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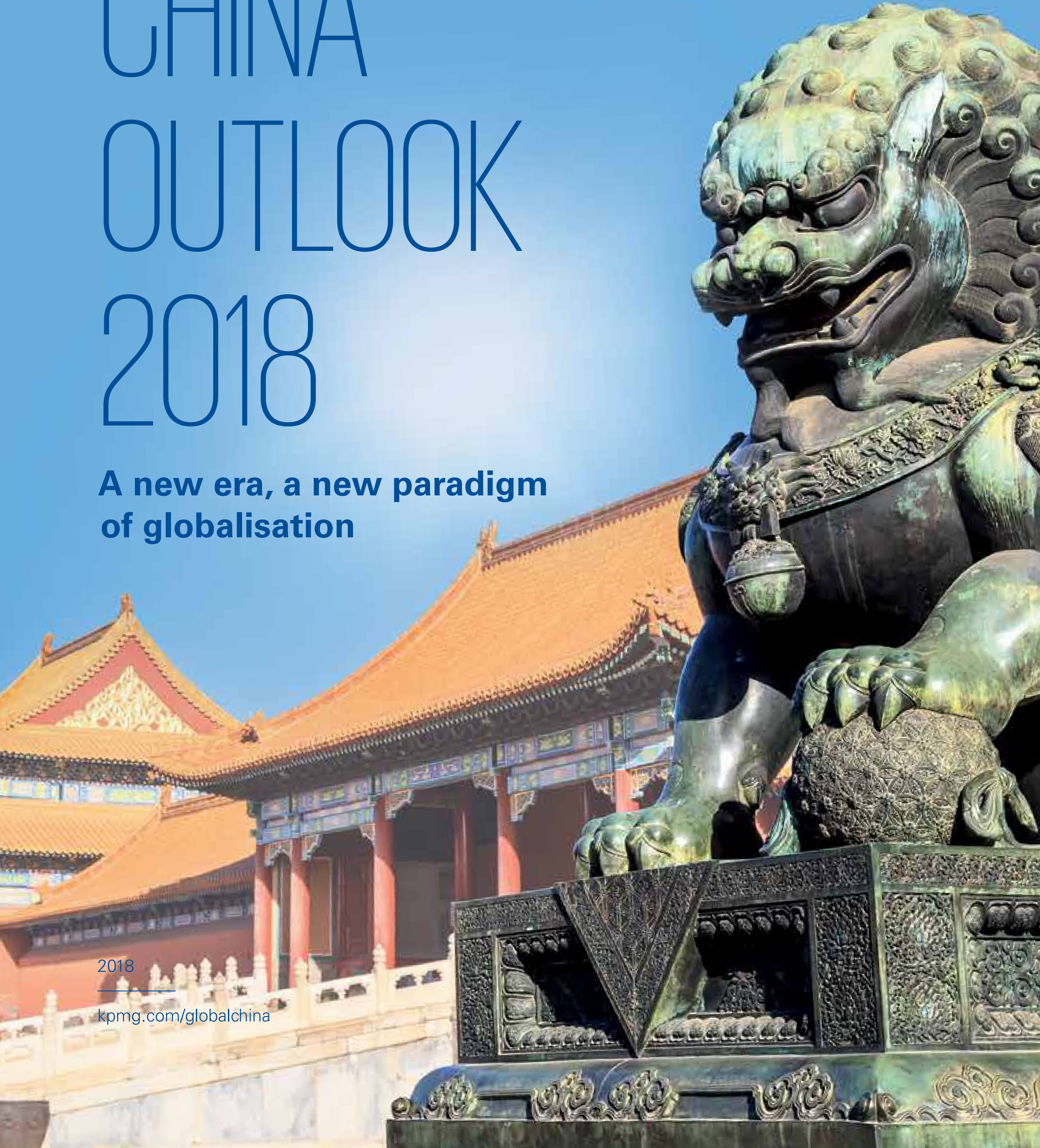
CHINA OUTLOOK 2018

A new era, a new paradigm of globalisation



2018

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Foreword

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2017 was a momentous year as China – the world's second-largest economy and largest developing economy[i] – signalled its intention to assume a global leadership role commensurate with its size and importance to global economic growth and prosperity.

First, amid a rising tide of protectionism, anti-globalisation sentiment and other economic and political issues, President Xi Jinping's keynote speech at the World Economic Forum in Davos delivered a memorable defence of "economic globalisation" that resonated with business and political leaders at the annual gathering.[ii]

Later in the year, China hosted the inaugural Belt and Road Forum for International Cooperation in Beijing. Consistent with his keynote speech at the World Economic Forum, rather than retreating from globalisation, the president provided a comprehensive prescription to address the problems identified. In expressly rejecting "outdated geopolitical manoeuvring", President Xi presented a compelling vision of the 'Belt and Road' Initiative as a new paradigm of coexistence, cooperation and development, with a "new model of win-win cooperation" at its core.[iii]

Then in October, the world's attention was once again focused on China as President Xi delivered his report to the 19th National Congress of the Communist Party of China. A cornerstone of that meeting was the adoption of *Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era*, which laid out a "new vision of development" and road map for "developing a modernised economy".[iv] Although the international media has not paid much attention to these aspects of the report, there were in fact many encouraging messages for foreign businesses: about accelerating the pace of 'opening up'; giving equal priority to 'bringing in' and 'going out'; significantly easing market access and further opening the service sector; and building a fairer and more open business environment.

As China enters this historic 'new era' in its economic, political, cultural and social development, KPMG China is pleased to present our analysis of what this means for the business environment and the development of inward and outward foreign direct investment in 2018 and beyond.

The key messages of this report are:

1. The implementation of President Xi's 'new vision of development', the emergence of a 'new economic cycle' in China, and the implementation of a 'new paradigm of globalisation' which is being advanced by the Chinese Government, will underwrite and determine the trajectory and characteristics of the country's inward and outward foreign direct investment in 2018 and beyond.

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[i] 'World Economic Outlook Database (October 2017)', IMF, accessed on 12 February 2018, http://www.imf.org/external/datamapper/datasets/WEO

[ii] 'Jointly Shoulder Responsibility of Our Times, Promote Global Growth (Keynote Speech by Chinese President Xi Jinping At the Opening Session Of the World Economic Forum Annual Meeting 2017)', The State Council Information Office, 17 January 2017, http://www.china.org.cn/node_7247529/content_40569136.htm

[iii] 'Work Together to Build the Silk Road Economic Belt and the 21st Century Maritime Silk Road', H.E. Xi Jinping, President of the People's Republic of China, 14 May 2017, http://www.xinhuanet.com/english/2017-05/14/c_136282982.htm

[iv] 'Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era (Delivered at the 19th National Congress of the CPC, October 18, 2017, Xi Jinping)', Xinhua News, 18 October 2017, http://www.xinhuanet.com/english/ download/Xi_Jinping's_report_at_19th_CPC_National_Congress.pdf

2. The recovery and steady growth in higher-quality investment into and out of China will support the ongoing transformation and upgrading of China's economy, as well as the vitality and resilience of global trade and investment flows.

3. Over the longer term, Chinese outbound investment and Chinese market demand will play a key role in the global economic recovery and the development of a new, more 'inclusive' model of globalisation, and will be important forces supporting global economic prosperity.

4. The reforms which the Chinese Government has announced to support foreign investment in China, enhance the supervision and regulation of market conduct, improve the management of cross-border investment flows, and deepen financial system reforms, will encourage two-way flow and connectivity of capital. However, they will necessitate certain changes in mindset and conduct by investors when thinking about how to benefit from the drivers and trends underlying the emergence of the 'new economic cycle' and the 'new paradigm of globalisation'.

5. Partnering between Chinese and international firms – including capital providers and financiers – will become a common feature in the 'new economic cycle' and under the 'new paradigm of globalisation'. This will help companies localise their investments and build trust with local and international stakeholders; complement their respective comparative advantages to jointly develop third-country markets; and locate more investable opportunities along the 'Belt and Road'.

Naturally, a key assumption underlying our report is that China does not suffer any major external geopolitical, security or economic shocks. With the prospect of an escalation in global trade tensions looming again, the hypothesis in our report provides a reference point for assessing the potential impact these actions could have on the economic outlook in China, the expected trajectory of reforms, and business opportunities for Chinese and foreign businesses.

In closing, President Xi's keynote address at the APEC CEO Summit last November provides a clear indication of the trade and investment flows that China's ongoing development will bring to the world:

> "In the next 15 years ... It is estimated that China will import USD 24 trillion worth of goods, attract USD 2 trillion inbound direct investment and make USD 2 trillion of outbound investment."[v]

Without a doubt, this represents a significant business opportunity for Chinese and foreign companies, and together with the broader blueprint and plan for how this will be achieved, constitutes a significant contribution towards and commitment by China to "build a community with a shared future for mankind".[vi]

We hope this report will help Chinese and foreign companies seize emerging opportunities and adapt to a changing business environment as China enters a 'new economic cycle', and a 'new paradigm of globalisation' takes shape. By making more, high-quality investments in China and overseas markets, these companies will contribute to and shape the emergence of a new period of economic development in China and prosperity in global investment and trade.

[v] 'Seizing the Opportunity of a Global Economy in Transition and Accelerating Development of the Asia-Pacific', H.E. Xi Jinping, President of the People's Republic of China, 10 November 2017, http://www.xinhuanet.com/english/2017-11/11/c_136743492.htm

[vi] 'Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era (Delivered at the 19th National Congress of the CPC, October 18, 2017, Xi Jinping)', Xinhua News, 18 October 2017, http://www.xinhuanet.com/english/ download/Xi_Jinping's_report_at_19th_CPC_National_Congress.pdf

Chapter 1

Business environment: China's 'new economic cycle' and the 'new paradigm of globalisation'

Over the past decade, China has become the largest contributor to global economic growth of any country.[1] In 2017, the Chinese economy began showing signs of recovery; while this recovery may not be a linear and uninterrupted process, preliminary indications suggest that a 'new economic cycle' is taking form. At the same time, the world has been presented with a 'China solution': a 'new paradigm of globalisation' built on the foundations of the 'Belt and Road' Initiative (BRI). The dawn of this 'new economic cycle' in the domestic Chinese economy and the beginning of the development of this 'new paradigm of globalisation' are important aspects of the business environment that inbound foreign investors and outbound Chinese investors will face in 2018. A proper understanding of these two important topics is essential to understand how the broader economic environment will shape China's inward and outward foreign direct investment (FDI).

1. China's economy enters the second half of an L-shaped recovery

On 9 May 2016, an article published on the front page of the *People's Daily* presented comments from an 'authoritative person' affirming that "the trend of China's economic growth will not follow a U-shape, and even less so a V-shape, but will instead likely follow an L-shape."[2] This description has since emerged as China's official narrative on the future growth trends of the domestic economy.

Following almost six consecutive years of growth slowdown, we believe China's economy bottomed out in 2017, signalling that the second half of its L-shaped recovery is close at hand. However, the foundations for this recovery remain unstable.

Because of this, foreign investors who are contemplating investing in China in the near term should understand the country's key economic trends and drivers. This will allow them to identify appropriate investment opportunities, and take appropriate steps to optimise their businesses in a way which aligns with the progress of China's economic recovery.

Chinese companies, for their part, should take advantage of the favourable conditions that will likely emerge in the 'new economic cycle', and make overseas investments that facilitate the transformation and upgrading of the domestic economy.

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[1] 'China will be the No. 1 engine of growth in the world economy for 10 years', Xinhua Silk Road Information Service, 10 January 2017, http://silkroad.news.cn/news/9786.shtml

[2] 'An expert's view on the Chinese economy based on the economic situation in the first quarter', People's Daily, 9 May 2016, http://politics.people.com.cn/n1/2016/0509/c1001-28333725.html

1.1 After the global financial crisis, China went through six years of declining growth

China's economic growth has declined steadily since the outbreak of the 2008 global financial crisis (Figure 1). While the stimulus measures introduced at the end of that year temporarily boosted growth back to double digits in 2010, the Chinese economy decelerated for the next six years.

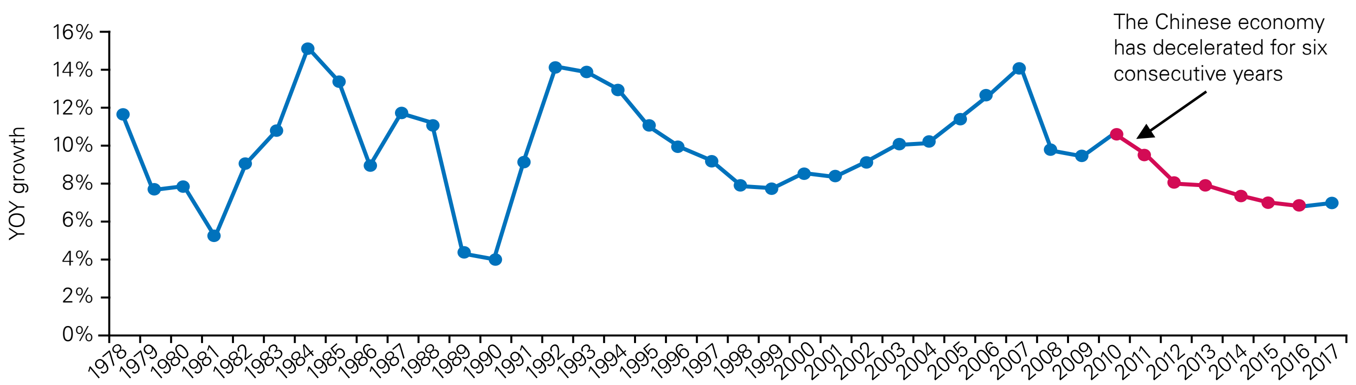
This slowdown has caused some multinational companies to question China's momentum and potential for continued growth, and some have even developed a bearish outlook on the Chinese economy in general. To some extent, this has had a negative effect on FDI into China. From 2009 to 2016, average annual growth in FDI fell to a relatively low level of around 5%, even experiencing negative growth in 2012.

1.2 Early signs of China's economic recovery began to emerge in the second half of 2016

China's growth slowed steadily for nearly six years, deepening concerns about the prospects of China's economy, both at home and abroad. In Q4 2016, however, China's GDP posted a slight uptick in quarterly growth (Figure 2). This trend continued into 2017, and resulted in an annual growth rate of 6.9% – well above the government's official target of 'around 6.5%'[3] and the GDP growth rate of 6.7% in 2016.

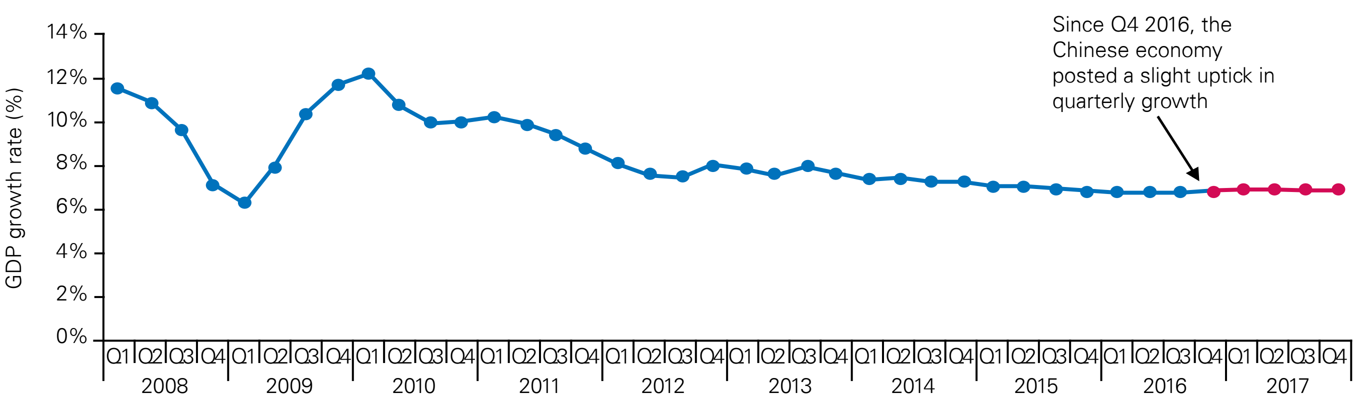
These developments have led some domestic and international observers to say that the Chinese economy may have bottomed out and is preparing to rebound. Foreign companies have also started paying attention to China's economic recovery, and in 2018, we expect more foreign companies to start re-examining their scepticism and 'wait-and-see' stance towards investing in China.[4]

Figure 1: Annual GDP growth rates in China



Source: National Bureau of Statistics of China

Figure 2: Quarterly GDP growth rates in China



Source: National Bureau of Statistics of China

[3] 'Report on the Work of the Government (Delivered at the Fifth Session of the 12th National People's Congress of the People's Republic of China on March 5, 2017)', Xinhua News, 16 March 2017, http://www.xinhuanet.com/english/china/2017-03/16/c_136134017.htm

[4] In the 2017 edition of the EU Chamber of Commerce's *Business Confidence Survey*, more than 60% of respondents rank China's slowing economic growth as their top concern. See: 'Business Confidence Survey 2017', The European Union Chamber of Commerce in China (EUCCC), May 2017, http://www.europeanchamber.com.cn/en/publications-business-confidence-survey

1.3 2018: Consolidating the foundations of China's economic recovery

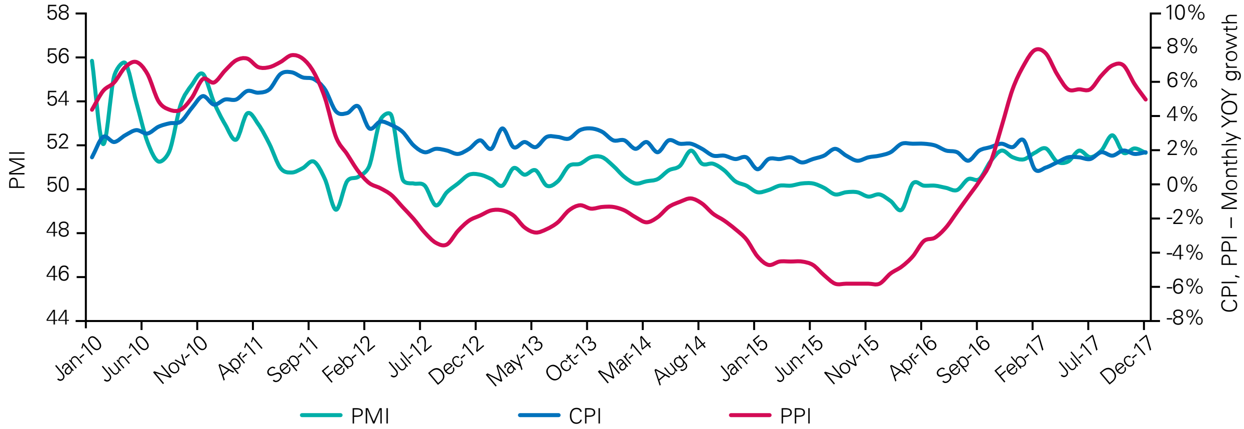
On 11 January 2018, the International Monetary Fund (IMF) made an upwards revision to its growth forecast for China for the fifth time in a row since January 2017.[5] Along with the positive performance of leading economic indicators, this suggests that China's recovery has entered a phase of consolidation (Figure 3).

In September 2016, China's Producer Price Index (PPI) ended a long streak of negative growth, registering positive year-on-year (YOY) growth since then, and over 4.5% in all months during 2017. Meanwhile, China's Purchasing Managers' Index (PMI) climbed back above the 50-point level in March 2016.[6] With the exception of a slight dip below 49.9 in July 2016, the PMI has otherwise remained above 50 points for the 21 months leading up to December 2017, with 15 consecutive months above 51.[7]

Barring another global financial crisis, and provided that the implementation of China's domestic structural reforms continues undeterred, we take the positive performance of these indicators as an indication that the Chinese economy will continue to stabilise and consolidate, with growth at or above 6.7% in 2018.

For companies, periods of economic consolidation are associated with uncertainty as well as unpredictability in terms of risks and returns. As such, these are often periods of observation rather than action. At the same time, relatively speaking, the beginning of a 'new economic cycle' also presents a unique opportunity for companies to invest and expand in the market while competition is relatively low. Consequently, this is an important time for foreign companies to assess what this next cycle of economic development in China means for them and to re-align their China-facing investment strategies accordingly.

Figure 3: Monthly performance of China's leading economic indicators



Source: National Bureau of Statistics of China

[5] The IMF's forecasts for China's growth in 2018 and 2019 have been revised upwards by 0.1 percentage points each to 6.6% and 6.4% respectively from the previous forecast released in October 2017. See: 'World Economic Outlook Update, January 2018: Brighter Prospects, Optimistic Markets, Challenges Ahead', IMF, January 2018, http://www.imf.org/en/Publications/WEO/Issues/2018/01/11/world-economic-outlook-update-january-2018

[6] The PMI is an indicator of the economic health and major trends in a country's manufacturing sector. Readings above 50 indicate an expansion of the manufacturing sector, while readings below 50 indicate a contraction.

[7] 'National Data Statistical Database', National Bureau of Statistics of China, accessed on 30 January 2018, http://data.stats.gov.cn/english/easyquery.htm?cn=A01

1.4 Twists and turns in China's L-shaped recovery

In the *People's Daily* front-page article, the 'authoritative person' noted that the L-shaped recovery is a phase that will not pass in a year or two.[8] While 2018 marks a period of stabilisation and consolidation in the Chinese economy, the foundations of its recovery remain unsteady, primarily due to the following factors:

- **Manufacturing sector profitability has started growing again, but investments in expanded production[9] remain difficult in the near term (Figure 4):**

  2016 marked a turning point for China's industrial sector, with years of profit deterioration giving way to new profit growth. Investment in manufacturing also saw a small rebound in 2017. However, profit growth is being concentrated primarily among upstream producers,[10] and in particular state-owned enterprises (SOEs) with high levels of short-term debt. As a result, the bulk of new profits are being used to service debts taken on in the aftermath of the financial crisis, rather than being reinvested in expanding production to make more advanced, better quality products.[11]

  There has only been a minimal rebound in investment in the manufacturing sector, and with a particularly noticeable lack of enthusiasm among private investors (Figure 4). A full recovery in the sector will require more time.

- **Real estate investment has stabilised, but future growth will be difficult to sustain (Figure 5):**

  Having bottomed out and rebounded in 2016, real estate investment emerged as a key factor in the stabilisation of the Chinese economy. That year, investment in real estate development saw a 6.9% YOY increase, up from 1% in 2015. This was driven by strong growth in property sales from the end of 2015 to Q1 2016.

  Beginning in the second half of 2016, however, the government's tightening of macro controls in the housing market led to a sharp decline in sales, which extended into 2017. These measures are likely to further impact investment levels in real estate development, and the real estate sector's contribution to growth may gradually weaken.

- **Infrastructure investment remains stable, but real growth in investment has slowed (Figure 6):**

  Since the financial crisis in 2008, China's investment in infrastructure has experienced a large slump and one major rebound. Investment in infrastructure has eased slightly since early 2013, but still maintained a medium-high growth rate of 14% in 2017, providing an important foundation for the near-term stabilisation of the overall economy.

  However, consistent investment in infrastructure has, in recent years, depended largely on deficit spending by the Chinese Government in an attempt to offset a drop in private investment and trade. Meanwhile, a steep jump in PPI (Figure 3) and material prices[12] means that while infrastructure investment levels remain stable, the absolute volumes of material input are actually decreasing. Coupled with this, uncertainties around the government's willingness to continue high levels of deficit spending, as well as increasingly limited space for new construction in the country,[13] suggest it would be very difficult for infrastructure investment to maintain an annual growth rate of around 15%.

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8 'An expert's view on the Chinese economy based on the economic situation in the first quarter', People's Daily, 9 May 2016, http://politics.people.com.cn/n1/2016/0509/c1001-28333725.html

9 'Expanded production' refers to expanding reinvestment to make more advanced, better quality products.

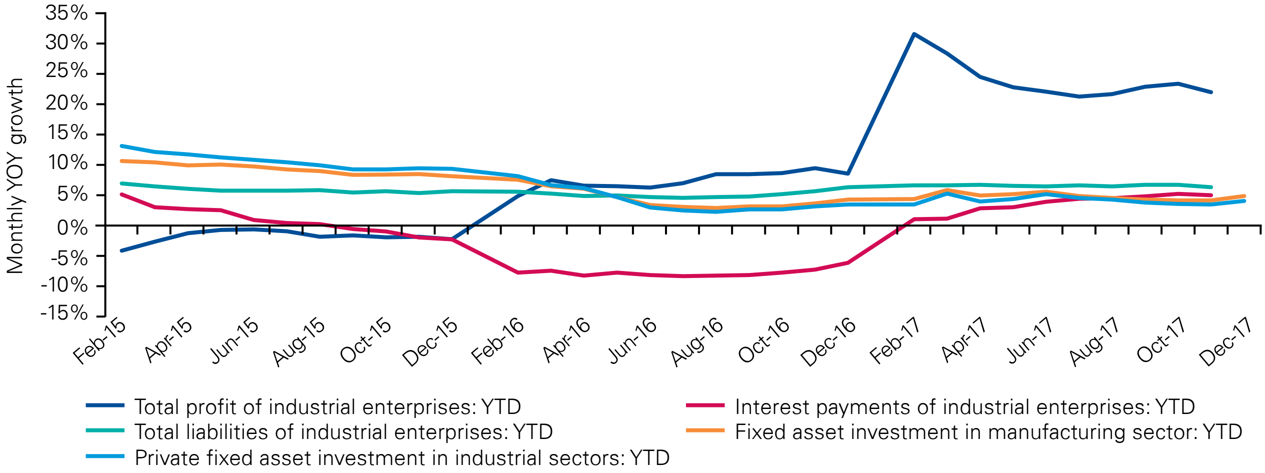
10 'Upstream producers' refers to enterprises which are engaged in the initial stage of production and business within the industry, mainly producing the raw materials and primary products for downstream enterprises. Upstream producers in the manufacturing industry include those engaged in the steel, coal, non-ferrous metals, petroleum and petrochemical sectors, etc.

11 'SOEs' profits soared by 40%, mainly driven by the recovery of the steel and coal sectors', Sina Finance, 29 March 2017, http://finance.sina.com.cn/roll/2017-03-29/doc-ifycstxp5321520.shtml; 'Chinese SOEs start paying debts', Caijing, 22 September 2017, http://economy.caijing.com.cn/20170922/4335682.shtml

12 'The upward trend of industrial raw material prices will continue', China Economic Net, 31 October 2017, http://www.ce.cn/cysc/newmain/yc/jsxw/201710/31/t20171031_26704566.shtml

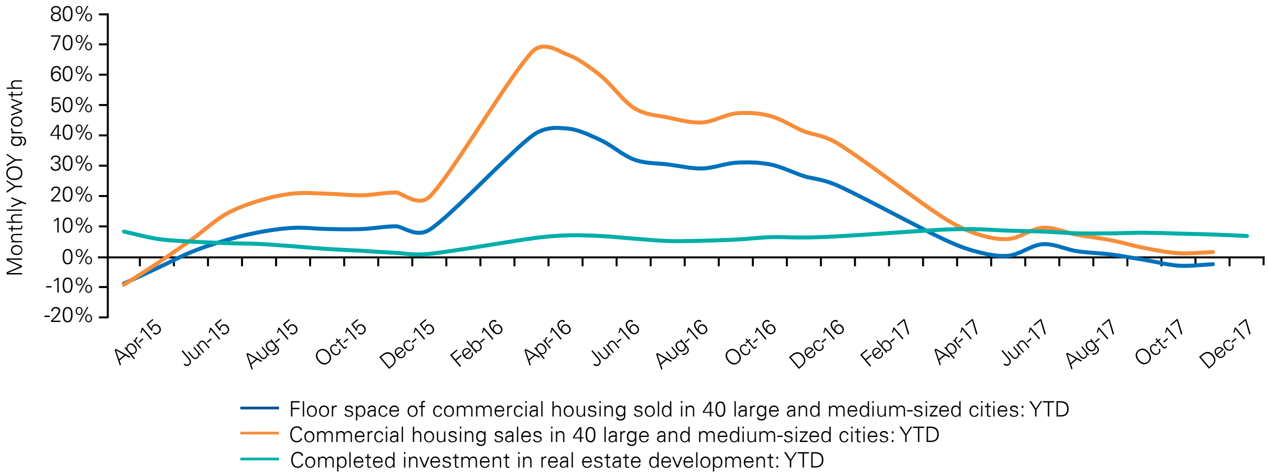
13 China's urbanisation and infrastructure development has transitioned from rapid growth to stable development. Therefore, it is difficult to see initiatives to boost domestic demand, such as the 'new urbanisation' effort, having a significant impact on the size of China's domestic infrastructure market. To this end, we expect that within 10 years, it is unlikely that China would have demand for the large-scale construction of new highways, high-speed railways, ports and airports. See: 'Outlook for China's infrastructure development in the next decade', Urban China Initiative, 16 November 2014, http://www.urbanchinainitiative.org/zh/content/details_59_48345.html

Figure 4: YOY growth in industrial sector performance, private investment and manufacturing investment in China, year-to-date



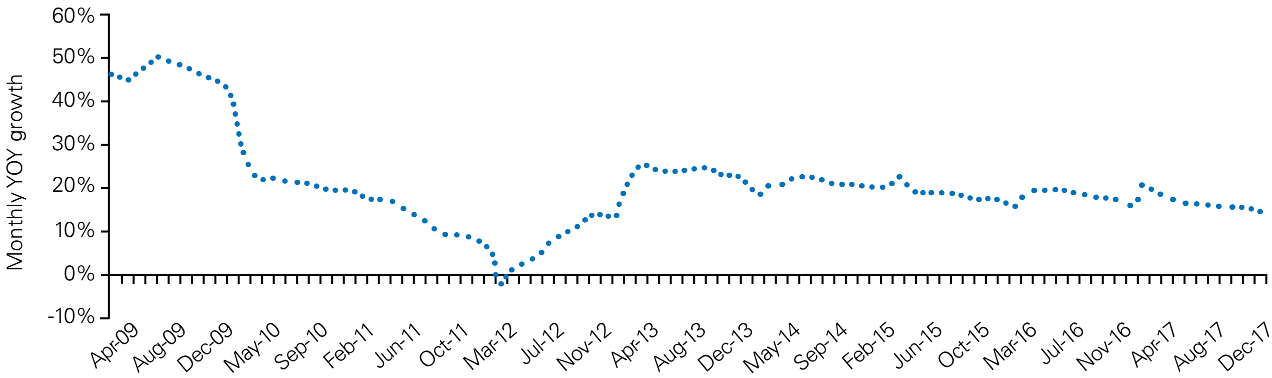
Source: National Bureau of Statistics of China; WIND

Figure 5: Monthly YOY growth in investment in real estate development investment and sales in China



Source: National Bureau of Statistics of China; WIND

Figure 6: YOY growth in monthly infrastructure investment in China, year-to-date



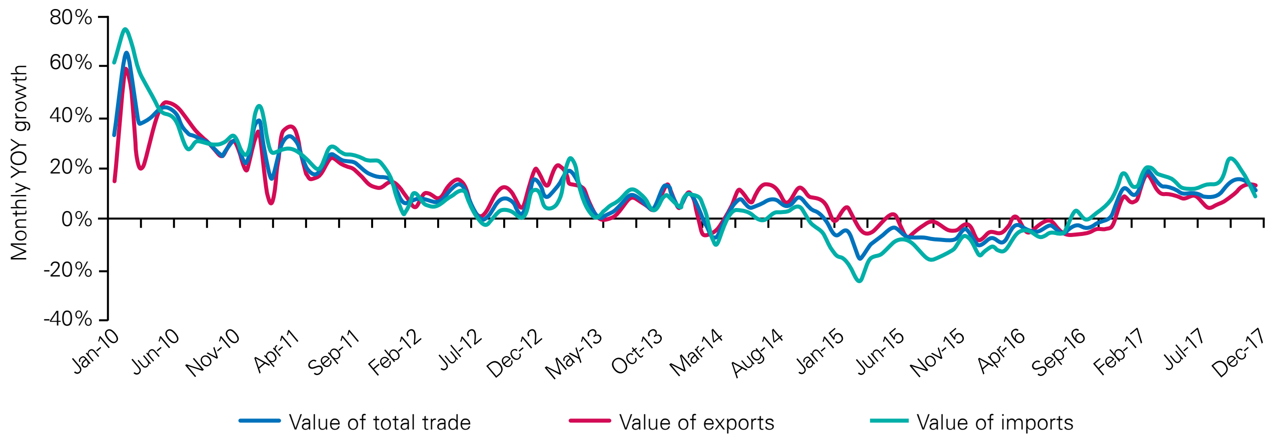
Source: National Bureau of Statistics of China; WIND

- **Trade is showing signs of recovery, but weak external demand will persist in the near term:**

  Due to the weakness of the global economic recovery, China's monthly import and export data posted negative growth in most months during 2015 and 2016. Since January 2017, however, improvements in the global economic climate have buoyed a rebound in China's trade volumes. Seasonally adjusted data shows that China's imports, exports and total trade in 2017 experienced monthly YOY growth rates of more than 4% during the whole year, reaching double-digit growth in many months (Figure 7).

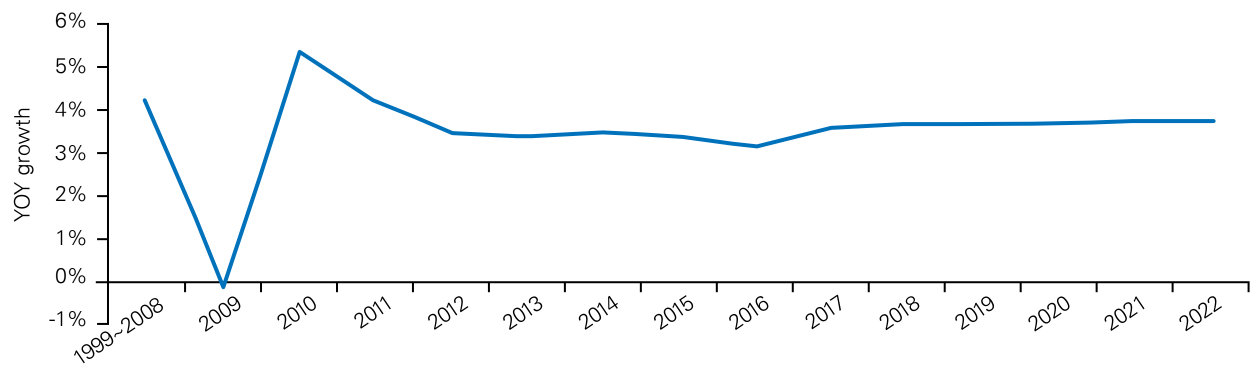
  Notwithstanding this, China's trade volumes are unlikely to recover to pre-2008 levels in the medium term. This is because even though global economic growth stabilised early last year, and is on track to rise to 3.8% by 2022 according to the IMF (Figure 8), this is still below the 4.2% average annual growth rate over the period from 1999 to 2008. This implies that it will require more time for external demand to return to pre-financial crisis levels.

Figure 7: Monthly YOY growth in China's imports, exports and total trade



Source: General Administration of Customs of the People's Republic of China; WIND
Note: Data is adjusted seasonally.

Figure 8: IMF's global growth forecasts



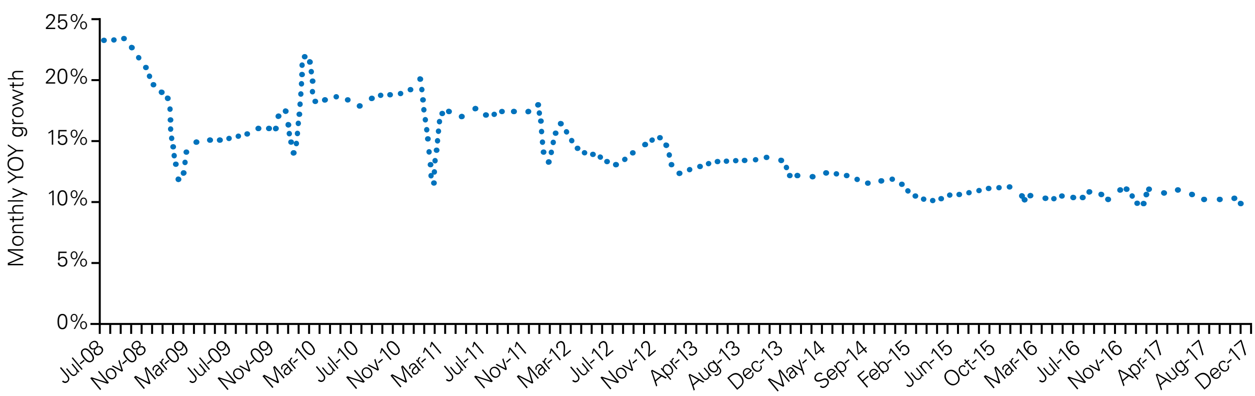
Source: IMF World Economic Outlook Database

- **Domestic consumption remains relatively stable, but faces emerging constraints to growth:**

  Official data shows that, with the exception of 2013, consumption has exceeded investment in terms of its annual contribution to economic growth since 2011.[14] However, this is partly due to a significant deceleration in investment. A close look at retail volumes, in fact, reveals a steady slowdown in consumption growth over the past years, with the YOY monthly growth decelerating to about 10% (Figure 9). At the same time, rural and urban household income growth has trailed behind GDP growth since 2016 (Figure 10), while absolute rates of urbanisation have slowed compared to recent years (Figure 11).[15] As such, it will be difficult for China's consumption growth to recover in the short to medium term to the relatively high level of 15% to 20% per year that it experienced between 2008 and 2011.

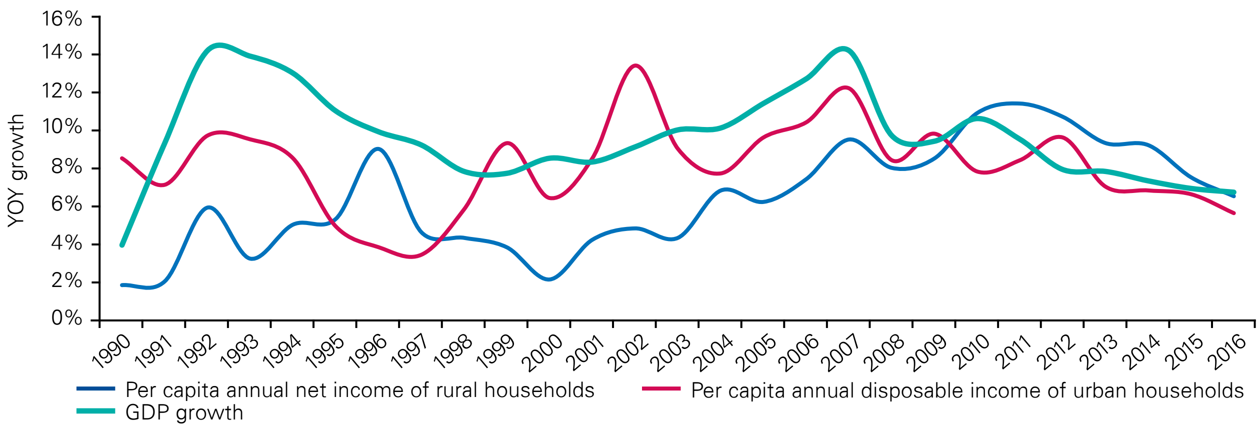
Overall, this means there are difficulties which need to be overcome for the Chinese economy to maintain sustained growth in the short to medium term. As a result, the L-shaped recovery will not follow a linear upward trend. Indeed, it may experience some reversals. Chinese and foreign companies should pay close attention to the contradictions and difficulties which need to be managed at the macroeconomic level, and the likely impact of these on the pace and form of the economic recovery that will take shape. This will inform better decisions about when and in what sectors to invest.

Figure 9: Monthly YOY growth of total retail sales of consumer goods in China



Source: National Bureau of Statistics of China; WIND

Figure 10: Real growth in urban and rural household income vs GDP growth in China

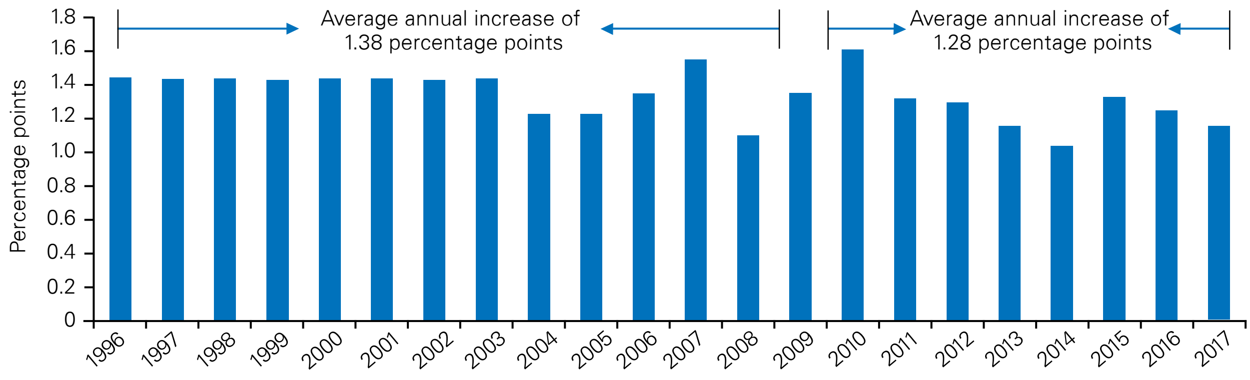


Source: National Bureau of Statistics of China; WIND

[14] 'National Data Statistical Database', National Bureau of Statistics of China, accessed on 30 January 2018, http://data.stats.gov.cn/english/easyquery.htm?cn=A01

[15] Based on official data from China's National Bureau of Statistics, our calculations show that from 2009 to 2017, China's average urbanisation rate rose by 1.28 percentage points per annum, which is lower than the average annual growth of 1.38 percentage points that the country experienced between 1996 and 2008.

Figure 11: Annual percentage point increases in China's urbanisation rate



Source: National Bureau of Statistics of China; WIND
Note: The urbanisation rate refers to the urban population as a proportion of the total population.

2. China on the verge of a 'new economic cycle'

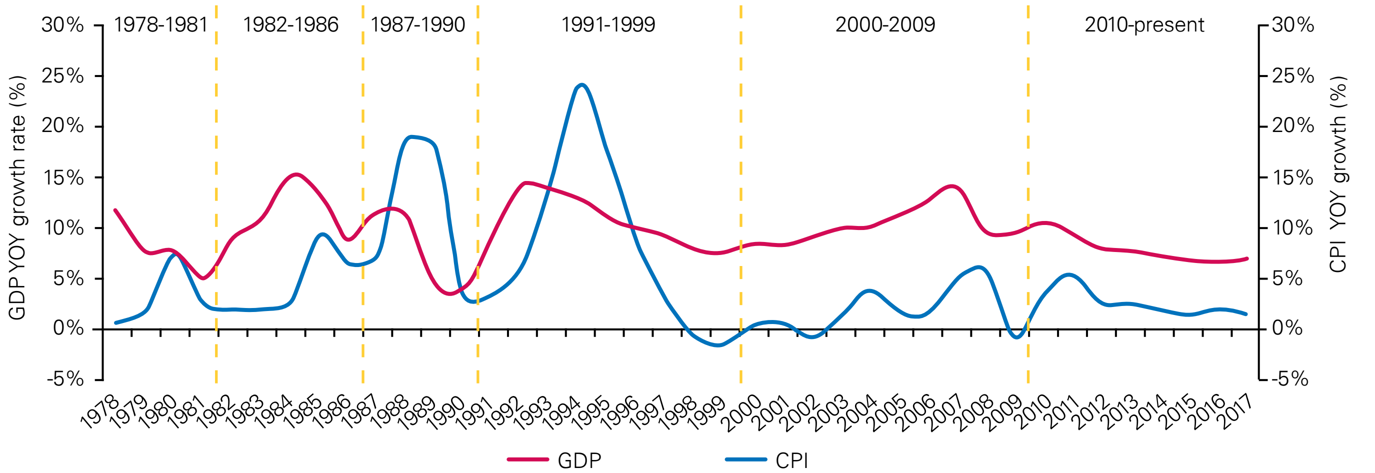
Since mid-2017, improvements across a number of economic indicators have sparked discussion among international observers about whether China's economy is entering a new cycle of growth. We believe this is indeed the case: while the country's economic recovery may be subject to relapses, there are early signs suggesting that the economy will enter a 'new economic cycle' as early as in 2018. We expect that these indications will become more apparent over time, and it may not be long before China enters a 'new economic cycle'.

2.1 The emergence of the seventh economic cycle since the 'reform and opening up' era began

Based on an analysis of China's growth trajectory and price movement trends, economists have identified six economic cycles – or cycles of growth – since the country's 'reform and opening up' era began in the late 1970s: 1978-1981, 1982-1986, 1987-1990, 1991-1999, 2000-2009, and 2010-present[16] (Figure 12). While the last economic cycle was characterised by its sustained growth slowdown, recent positive performance in leading economic indicators (Figure 3), industrial data (Figure 13), and relevant corporate data (Figure 4) suggest that China's economic slowdown may have bottomed out, and a seventh cycle of growth is about to emerge.

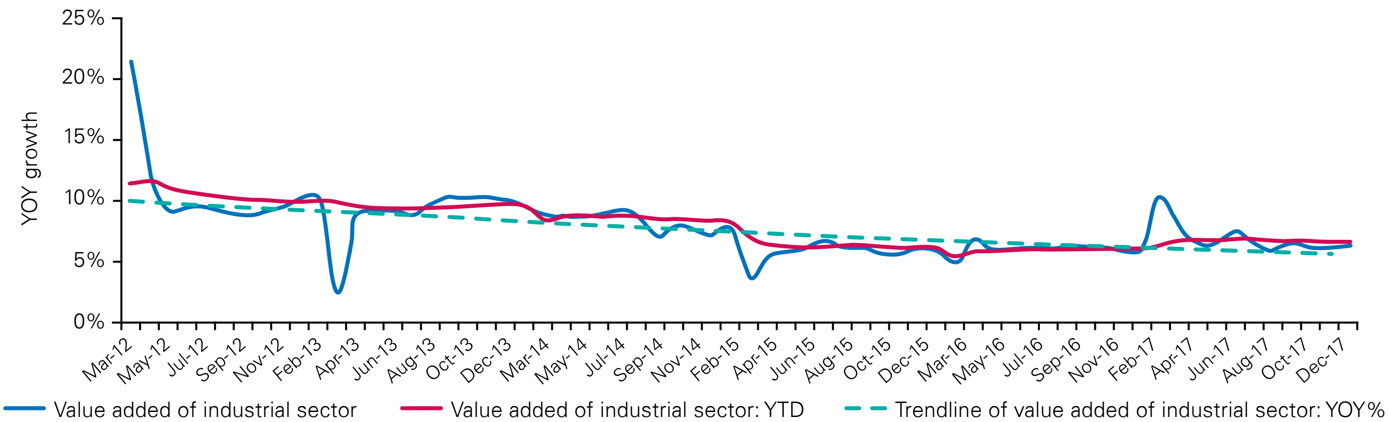
For foreign companies, the arrival of a new cycle signifies a wave of new investment opportunities in China.[17] For Chinese companies, the new cycle can bring profit growth, relieve debt burdens and provide a lasting impetus for investment, thereby increasing the capacity and propensity for Chinese companies to make overseas investments.

Figure 12: China's six economic cycles



Source: National Bureau of Statistics of China

Figure 13: Value added growth in China's industrial sector



Source: WIND

[16] 'The Dividend of Reform and the Vitality of Development', edited by the Macroeconomic Research Institute of the NDRC and published by People's Publishing House, November 2013

[17] As explained in section 1.3 of Chapter 1, the beginning of a 'new economic cycle' presents more opportunities for companies to expand with less competition. In this sense, China's consolidation phase offers companies a unique opportunity to invest.

2.2 Supply-side structural reforms provide a strong foundation for the 'new economic cycle'

Since 2016, the Chinese Government has promoted supply-side structural reforms with five major tasks: reducing industrial capacity, housing inventories, financial leverage and costs, as well as correcting structural shortcomings. The preliminary results of these reforms have created positive conditions for the emergence of the 'new economic cycle'.

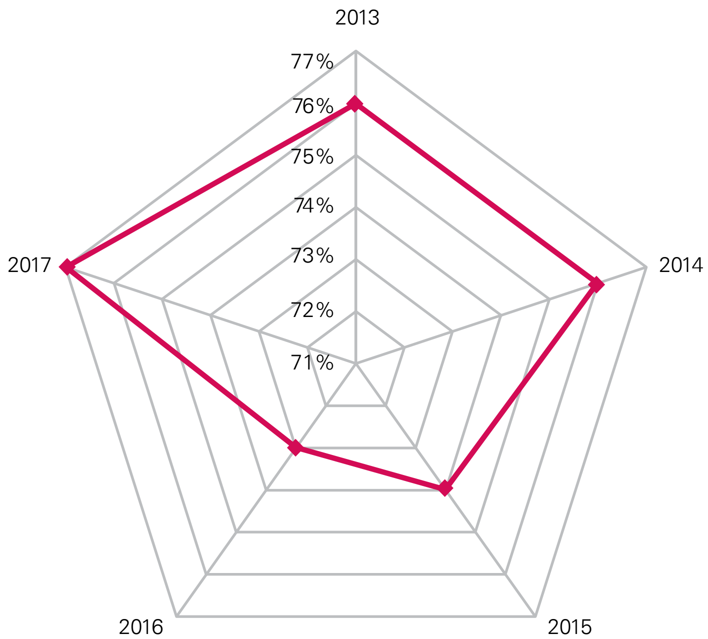
- **Reducing overcapacity has improved the utilisation of industrial production capacity:**

  In February 2016, China's State Council released two guiding documents which instructed coal and steel producers to cut 500 million tons (MT) of coal production capacity; restructure another 500MT within three to five years; and eliminate between 100MT and 150MT of steel production capacity within five years beginning in 2016.[18] Additional guidance was issued to encourage the elimination of inefficient production capacity in the non-ferrous metals industry and other sectors suffering from overcapacity.

In 2016, China eliminated over 65MT of steel production capacity and 290MT of coal production capacity, while in 2017 steel production capacity was cut by over 50MT and coal production capacity by over 150MT.[19] At the same time, the decommissioning of coal-fired power stations as well as the halting and postponement of the construction of new units led to a generation capacity reduction of over 50GW. Overall, by the end of 2017, China had successfully achieved nearly 90% of the capacity reduction targets for coal and 76% of the targets for steel it had set for the period of 2016-2020.[20]

Thanks to the government's concerted implementation of capacity reduction policies, China's industrial sector has shown signs of a `double rebound' in both industry value added and corporate profits since 2016 (Figures 4 and 13). In 2017, the capacity utilisation rates of China's industrial sector reached 77%, the highest level over the past five years (Figure 14). These improvements have laid a strong foundation for a new cycle of economic growth.

Figure 14: Capacity utilisation rate of China's industrial sector



Source: National Bureau of Statistics of China
Note: The industrial sector's capacity utilisation rate measures industrial enterprises' total actual industrial output per year as a proportion of their total planned output capacity.

[18] The two guiding documents in question are: 'Opinions of the State Council on Reducing Overcapacity in the Coal Industry to Achieve Development by Solving the Difficulties', State Council of the People's Republic of China, 5 February 2016, http://www.gov.cn/zhengce/content/2016-02/05/content_5039686.htm; and 'Opinions of the State Council on Reducing Overcapacity in the Iron and Steel Industry to Achieve Development by Solving the Difficulties', State Council of the People's Republic of China, 4 February 2016, http://www.gov.cn/xinwen/2016-02/04/content_5039386.htm

[19] 'Press Conference by the Chief of the National Bureau of Statistics to introduce the overall situation of the Chinese economy in 2017', National Bureau of Statistics of the People's Republic of China, 18 January 2018, http://www.stats.gov.cn/tjsj/sjjd/201801/t20180118_1575270.html

[20] The State Council set the target of cutting 500 million tons of coal production capacity between 2016 and 2020. Over the course of 2016, China eliminated 290 million tons of coal production capacity; in 2017, China cut coal production capacity by at least 150 million tons. Based on this data, China achieved nearly 90% of its capacity reduction targets for coal by the end of 2017, i.e. (290+150)/500x100%=88%

The State Council set the target to eliminate between 100-150 million tons of steel production capacity between 2016 and 2020. Over the course of 2016, China eliminated over 65 million tons of steel production capacity; in 2017, China cut steel production capacity by over 50 million tons. Based on this data, China achieved nearly 76% of its capacity reduction targets for steel by the end of 2017, i.e. (65+50)/150x100%=76%

- **Growth in the Chinese economy's leverage ratio has decelerated as a result of deleveraging efforts by Chinese authorities:**

  In 2016, China started promoting corporate consolidation and restructuring, as well as direct financing and debt-for-equity swaps based on market and legal principles. Debt-to-asset ratios among industrial companies decreased correspondingly, while local government debt swaps[21] grew in scale, reducing interest payments by roughly RMB 400 billion (USD 60.2 billion).[22]

  In 2017, the Chinese Government continued encouraging companies to put their idle assets to use; promoting the securitisation of corporate assets; supporting market- and law-based debt-to-equity swaps; expanding equity financing; and, placing tighter restrictions on companies, especially SOEs, in terms of leveraging. Furthermore, there were more local government debt swaps, which helped further reduce the debt burden at the local level.[23]

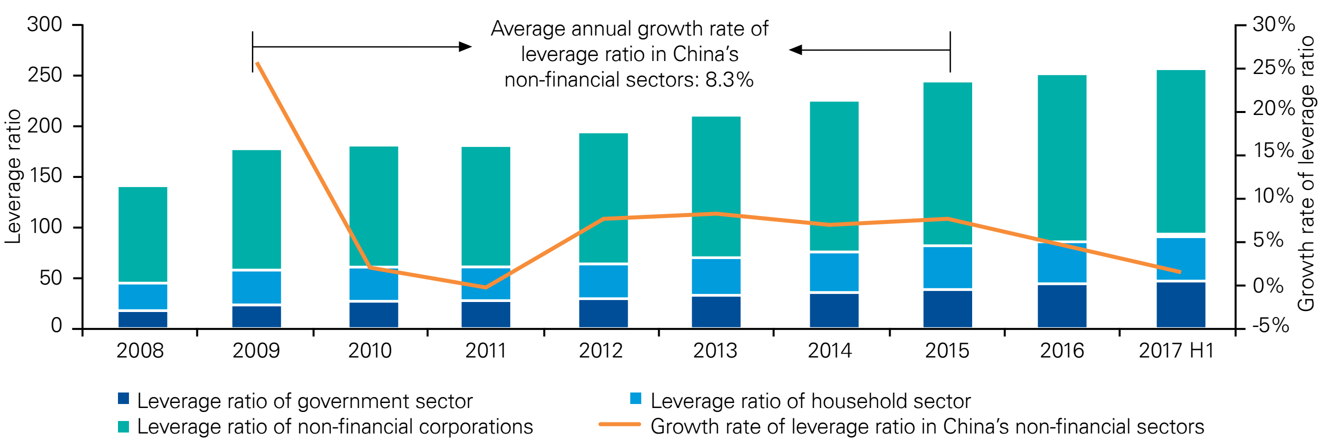
  As a result of these deleveraging efforts, the annual YOY growth in the leverage ratio of China's non-financial sector has decreased from an average of 8.3% in the period 2009-2015 to 4.9% in 2016. Moreover, in the first half of 2017, the YOY growth in the leverage ratio slowed to 1.6% (Figure 15).

  Going forward, China's industrial firms may find it difficult to maintain the high levels of profit growth that they experienced in early 2017 – i.e. over 20% each month (Figure 4). However, profit growth rates will still remain higher than the low and even negative ones experienced between 2008 and 2016.

  Companies' debt servicing capacity is improving, which should lead to a slowdown in debt accumulation and, over time, an eventual decline in overall outstanding debt. The IMF also forecasts that China will maintain a medium-to-high growth rate of at least 6% in the coming years.[24] Under such conditions, the leverage ratio growth of the country's non-financial sectors can be expected to decline even further.[25]

  As the debt burden is reduced across China's economy, systemic risks associated with high leverage ratios are eased, creating a positive investment and financing environment to support economic recovery, and the beginning of a 'new economic cycle'.

Figure 15: Change in the leverage ratio of China's non-financial sector



Source: Bank for International Settlements

Note: Non-financial companies include state-owned and non-state-owned non-financial companies. Debt of state-owned non-financial companies is said to account for roughly 70% of total debt in the non-financial sector.[26]

[21] Local government debt swaps: On the basis of an assessment of the local debt stock, the Ministry of Finance issues medium- to long-term low-cost bonds to refinance short-term, high-interest debts in the form of bank loans, wealth management products, municipal infrastructure bonds, etc.

[22] RMB to USD conversions calculated based on the average exchange rate in 2016

[23] 'Report on the Work of the Government (Delivered at the Fifth Session of the 12th National People's Congress of the People's Republic of China on March 5, 2017)', Xinhua News, 16 March 2017, http://www.xinhuanet.com/english/china/2017-03/16/c_136134017.htm

[24] 'World Economic Outlook Database (October 2017)', IMF, accessed on 30 January 2018, http://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD

[25] The non-financial sector leverage ratio is equal to the total liabilities of the non-financial sector divided by GDP. Currently, these liabilities are growing at a declining rate and may experience negative growth in the future, while GDP is expected to maintain a medium to high level of growth. Therefore, the non-financial sector leverage ratio is expected to decelerate, with an absolute reduction possible in the medium term.

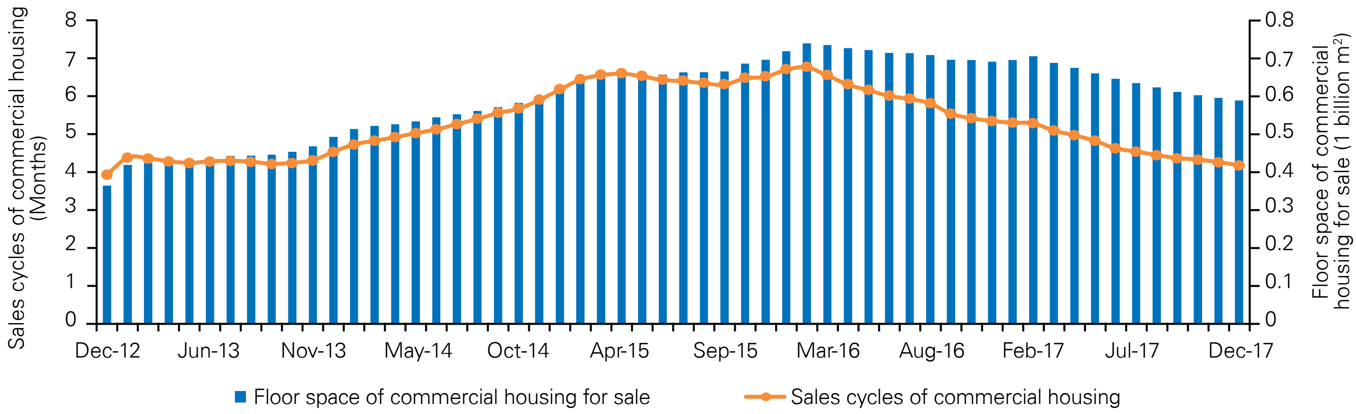
[26] 'China's non-financial companies have the highest leverage ratios in the world; the key to deleveraging lies with state-owned enterprises', Sina News, 10 September 2016, http://finance.sina.com.cn/roll/2016-09-10/doc-ifxvueif6433219.shtml

- **Efforts to reduce housing inventories have led to substantial de-stocking in the real estate market:**

  Over recent years, the Chinese Government has increased its efforts to reduce excess inventories in the property markets. Since the beginning of 2016, the government has encouraged migrant workers to buy urban homes, and increased the use of monetary compensation when relocating people affected by rebuilding in rundown urban areas.[27] In 2017, the government implemented targeted policies to cut excess urban housing inventory; supported both local and new residents in buying homes for personal use; improved the housing system for renting and purchasing; increased the supply of land for residential property development in supply-constrained municipalities; improved regulation around real estate development, sales and agency; renovated over 6 million homes in shanty towns; continued the development of subsidised rental and other public housing programmes; increased the use of monetary compensation for those affected by rebuilding in rundown urban areas; and improved public services and facilities.[28]

  Two years of inventory reduction have shrunk China's housing stock and shortened sales cycles (Figure 16). The successful implementation of inventory reduction policies in the real estate market has helped reduce the risks posed by a housing glut, and laid the necessary conditions for China's economy to steadily enter into a new cycle.

Figure 16: Inventory levels and sales cycles in China's real estate market



Source: National Bureau of Statistics of China; WIND
Note: Inventory level is narrowly defined as the total floor space of unsold commercial residential property divided by the average floor space of property sold over the past 12 months.

[27] The redevelopment of rundown urban areas is a social welfare initiative of the Chinese Government to renovate old and dilapidated urban housing, and improve the living conditions of underprivileged households. 'Resettlement compensation scheme' in this context refers to three practices: (i) the government sets up a platform through which available inventories from commercial real estate developers can be purchased independently and at reasonable prices by relocated households; (ii) the government purchases commercial property to resettle relocated households; and (iii) relocated households receive direct cash compensation from the government. See: 'Opinions of the State Council on Accelerating the Redevelopment of Rundown Urban Areas', State Council of the People's Republic of China, 12 July 2013, http://www.gov.cn/zhengce/content/2013-07/12/content_4556.htm

[28] 'Report on the Work of the Government (Delivered at the Fifth Session of the 12th National People's Congress of the People's Republic of China on March 5, 2017)', Xinhua News, 16 March 2017, http://www.xinhuanet.com/english/china/2017-03/16/c_136134017.htm

- **Reducing costs in the real economy:**

  Reducing costs to businesses has been an important priority in the government's recent efforts to stimulate the real economy – i.e. the actual production of goods and services as opposed to buying and selling in the financial markets.[29]

  In 2016, the government launched a broad pilot programme to replace business tax (BT) with value-added tax (VAT), effectively reducing the annual corporate tax burden by RMB 570 billion (USD 85.8 billion) across all industries that year.[30] China also reduced corporate taxes and levies, social security liabilities and electricity costs to companies.

  In 2017, Chinese authorities announced their intention to further reduce the tax burden on enterprises by RMB 350 billion (USD 51.8 billion) and cut RMB 200 billion (USD 29.6 billion) in business levies; increase the number of small businesses that can enjoy a halved corporate income tax rate by raising the upper limit of taxable annual income from RMB 300,000 (USD 44,400) to RMB 500,000 (USD 74,000); and raise the proportion of R&D expenses that are tax deductible for high-tech small- and medium-sized enterprises (SMEs) from 50% to 75%.[31]

  Chinese authorities also worked to overhaul government-managed funds; abolish or suspend administrative levies paid by enterprises to the central government; reduce the operating fees which are set by the government for businesses; and lower social security contributions borne by employers.[32]

  These initiatives have considerably reduced companies' operating costs. It is expected they will stimulate growth in the real economy, and lay the foundations for long-term stability in the 'new economic cycle'.

- **Addressing weaknesses leads to strengthening of vulnerable sectors:**

  According to the 13th Five-Year Plan, a priority for the Chinese Government in the coming years is to address economic vulnerabilities by reducing poverty, increasing environmental protection, and promoting innovation.

  In terms of poverty alleviation, the Chinese Government aims to lift about 50 million people out of poverty by 2020.[33] In line with this goal, in 2016, national and provincial treasuries deployed over RMB 100 billion (USD 15 billion)[34] in poverty alleviation funds, representing YOY increases of 43.4% at the national level and over 50% at the provincial level, and effectively lifting 10 million people out of poverty.[35]

  In 2017, the government implemented a programme of 'targeted poverty reduction and elimination measures',[36] with increased funding and policy support. The national fiscal support for poverty alleviation increased by over 30%, helping to lift an additional 10 million people out of poverty, including by relocating 3.4 million people out of poverty-stricken regions.[37]

  In terms of innovation, the Chinese Government has actively cultivated new industries; encouraged innovation in technology, products and business models; and sought to establish a platform for high-end R&D.[38] China's investment in R&D as a proportion of GDP reached 2.11% in 2016 and 2.12% in 2017, approaching the world's average and that of the Organisation for Economic Co-operation and Development (OECD) (Table 1).

  Furthermore, the government also continued increasing its investment in environmental governance, which had grown at an annual average of around 14% from 2008 to 2016 to reach RMB 922.0 billion (USD 138.9 billion;[39] see Figure 17). Thanks to the steady increases in government funding for environmental protection, China has experienced significant environmental and ecological improvements (see Chapter 2, Section 2.2 for more information).

  Going forward, Chinese authorities will continue working to address these 'weaknesses' so as to help bring relevant areas and sectors to a level of development which supports and is conducive to China entering the 'new economic cycle'.

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29 'Definition of Real Economy', Financial Times Lexicon, Financial Times, accessed on 2 February 2018, http://lexicon.ft.com/term?term=real-economy

30 'Report on the Work of the Government (Delivered at the Fifth Session of the 12th National People's Congress of the People's Republic of China on March 5, 2017)', Xinhua News, 16 March 2017, http://www.xinhuanet.com/english/china/2017-03/16/c_136134017.htm

31 'Report on the Work of the Government (Delivered at the Fifth Session of the 12th National People's Congress of the People's Republic of China on March 5, 2017)', Xinhua News, 16 March 2017, http://www.xinhuanet.com/english/china/2017-03/16/c_136134017.htm

32 'Report on the Work of the Government (Delivered at the Fifth Session of the 12th National People's Congress of the People's Republic of China on March 5, 2017)', Xinhua News, 16 March 2017, http://www.xinhuanet.com/english/china/2017-03/16/c_136134017.htm

33 'The 13th Five-Year Plan for Economic and Social Development of The People's Republic of China (2016-2020)', NDRC, 7 December 2016, http://en.ndrc.gov.cn/newsrelease/201612/P020161207645765233498.pdf

34 RMB to USD conversions calculated based on the average exchange rate in 2016

35 'Two sessions insight: 10 million rural residents lifted out of poverty in 2016', China.com, 1 March 2017, http://news.china.com/2017lh/hotnews/13000335/20170301/30290772.html

36 'Targeted poverty reduction and elimination measures' refers to the precise identification, intervention and management of poverty based on a differentiated and systematic assessment of regional and local household conditions.

37 'National work meeting about poverty alleviation held to identify 13 work priorities for 2018', Guangming Daily, 29 December 2017, http://economy.gmw.cn/2017-12/29/content_27226149.htm

38 This refers to creating a favourable environment for R&D cooperation, as well as supporting research institutions, universities, academies and enterprises to conduct R&D activities in the high-tech and high value added fields through cooperation, e.g. establishing joint R&D funds and research laboratories. For more information see: 'The 13th Five-Year Plan for National Technology Innovation Projects', Ministry of Science and Technology, 24 April 2017, http://www.most.gov.cn/mostinfo/xinxifenlei/fgzc/gfxwj/gfxwj2017/201705/t20170503_132603.htm

39 RMB to USD conversions calculated based on the average exchange rate in 2016

The history of China's development since the 'reform and opening up' era began indicates that the 'new economic cycle' cannot emerge without the changes brought by reform.

The implementation of the five main tasks of reform described in the previous pages lay the foundation, provide favourable conditions, and improve the environment for the emergence of a 'new economic cycle'. In fact, when delivering his Work Report to the 19th Communist Party of China (CPC) National Congress, President Xi Jinping affirmed that China will continue implementing 'structural supply-side reforms' to address these five main tasks, as well as to achieve a dynamic equilibrium between supply and demand by improving the allocation of available resources and increasing high-quality supply.[40]

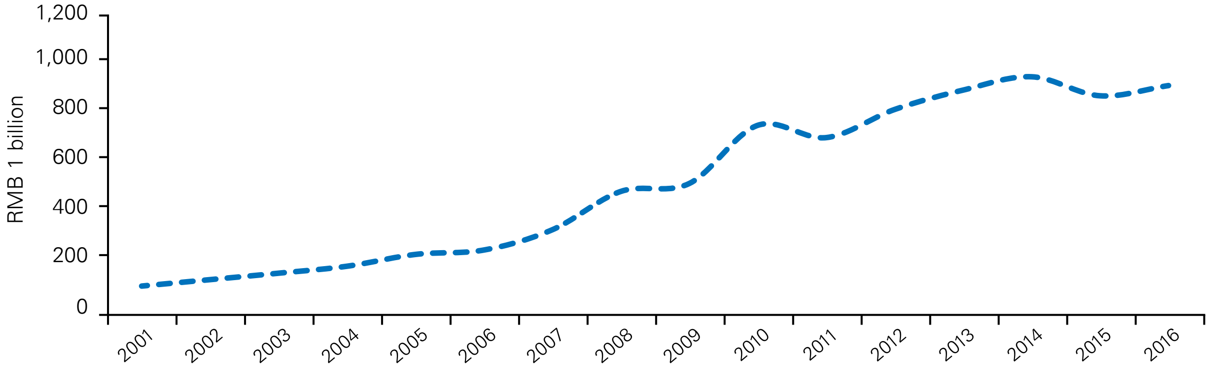
As such, when looking to understand the direction and progress of China's economic development and making decisions about investing in the Chinese market, it is important for foreign companies to understand the details, implementation and impact of these reforms.

Table 1: Comparison between China and other countries in R&D investment as a proportion of GDP (%)

	China	Global average	OECD average	US	India	Japan	UK	Germany	Israel
2010	1.71	2.04	2.37	2.73	0.82	3.14	1.68	2.71	3.94
2011	1.78	2.02	2.4	2.77	0.83	3.25	1.68	2.80	4.02
2012	1.91	2.09	2.42	2.70	-	3.21	1.61	2.87	4.16
2013	1.99	2.06	2.41	2.74	-	3.32	1.66	2.82	4.14
2014	2.02	2.15	2.45	2.75	-	3.40	1.68	2.89	4.29
2015	2.07	2.23	2.55	2.79	0.63	3.28	1.70	2.88	4.27
2016	2.11	-	-	-	-	-	-	-	-
2017	2.12	-	-	-	-	-	-	-	-

Source: National Bureau of Statistics of China; Ministry of Science and Technology of the People's Republic of China; World Bank
Note: Data unavailable for some countries and years.

Figure 17: Investment in environmental governance in China



Source: National Bureau of Statistics of China; WIND

[40] 'Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era (Delivered by Xi Jinping at the 19th National Congress of the CPC)', Xinhua News, 18 October 2017, http://www.xinhuanet.com/english/download/Xi_Jinping's_report_at_19th_CPC_National_Congress.pdf

2.3 *The 19th CPC National Congress – a political starting point for the 'new economic cycle'*

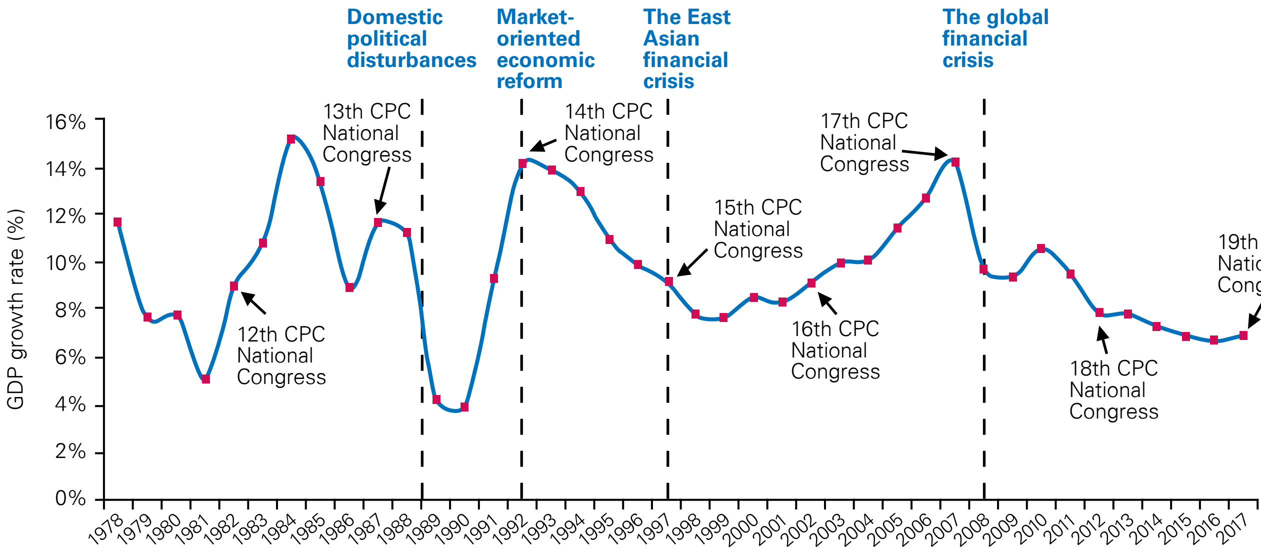
Insight into the 'new economic cycle' is derived not only from observing China's economic performance and trends, but also from looking at its political cycles. While China has undergone more than three decades of market-oriented reform, the government continues to exert a relatively strong guiding force on economic development.

Our observations suggest that in the period leading up to and following the CPC National Congress held every five years, the desire to create a positive political climate combined with the imperatives of an administration in transition mean that the propensity of central and local governments to invest will increase markedly, and more policies which are advantageous to the economy will be promulgated and implemented during this period. This means that the Chinese economy also features political cycles of growth every five years or so – a so-called 'political bump'. So, while China's GDP grew at an average annual rate of 9.7% from 1981 to 2016, the average growth in the years during which the CPC National Congresses were held was 10.7%.

Looking back, the Chinese economy enjoyed boom cycles directly following the 12th and 16th CPC National Congresses (i.e. 1982 and 2002 respectively) which were held in years without disruptions from any global or regional economic crises. Conversely, the socialist market reforms that were implemented after the 14th CPC National Congress (i.e. 1992) led to a period of economic adjustment which suppressed growth and caused a seven-year slump in the 1990s. However, these reforms also laid positive institutional foundations for nearly a decade of accelerated growth between 1999 and 2007 (Figure 18).

According to the Work Report delivered at the 19th CPC National Congress, "socialism with Chinese characteristics" has entered a new era and China will gradually embark on a journey to fully build a "modern socialist country".[41] Given the extended reform cycle that China has undergone since 2013 and provided there is no serious economic crisis in China or the world, it is reasonable to expect that China will soon enter a 'new economic cycle'. Many years of experience show that having a firm grasp of China's political cycle is an important prerequisite for foreign companies to invest successfully in China and for Chinese companies to invest abroad. By following the direction and momentum of policy changes, companies can stay in sync with unfolding changes in economic cycles to capture opportunities, reduce risks, and grow (see Chapter 4 Section 3.2 for further analysis of the expected impacts of the 19th CPC National Congress on FDI and ODI).

Figure 18: Economic growth and political cycles in China



Source: National Bureau of Statistics of China; KPMG analysis

[41] 'Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era (Delivered by Xi Jinping at the 19th National Congress of the Communist Party of China)', Xinhua News, 18 October 2017, http://www.xinhuanet.com/english/download/Xi_Jinping's_report_at_19th_CPC_National_Congress.pdf

2.4 The 'new economic cycle' signals China's third 30-year period of economic transformation

From the founding of the People's Republic of China in 1949 until 2009, the Chinese economy has undergone two 30-year periods of economic growth. During the first of these, China asserted its economic self-reliance and transitioned to a heavy industrial economy built on a relatively modern industrial system. However, its economic dynamism was destroyed by political movements and the shortcomings of a planned economy. During the second 30-year period, China's 'reform and opening up' unlocked a wave of pent-up dynamism, and a major emerging economy was born. However, structural deficiencies and imbalanced growth undermined the economy's capacity for sustained growth. These two 30-year periods were driven by institutional reforms and economic transformation.

Since 2009, a combination of factors, including the global financial crisis, internal and external structural imbalances, and cyclical trends, have resulted in an extended lead-up towards China's third 30-year period. However, starting in the second half of 2016, we began to see signs of recovery in the Chinese economy (see Figure 3 for detailed indicators), while at the same time, the Chinese Government has quickened the pace of the supply-side structural reforms and deepened both economic and institutional reforms.

As the Work Report of the 19th CPC National Congress notes, "China's economy has been transitioning from a phase of rapid growth to a stage of high-quality development". This is a pivotal stage for transforming China's growth model, improving China's economic structure and fostering new drivers of growth.[42]

All this indicates that China's economic transformation and institutional reforms are poised to unleash a powerful force of growth in the 'new economic cycle', which also stands to become the first cycle of prosperity in the next 30-year period.

2.5 The engines of the 'new economic cycle' are evolving relative to those of the 'old economic cycle'

China's economic cycles are 'driven' by industry, 'pulled' by demand and 'supported' by regional context. Thirty years of fast-paced development and the evolution of the economy have led to structural changes in these three forces, and will result in the following notable changes relative to the engines that drove the previous economic cycle.

- **The services sector, in particular producer services, and the high-tech sector will be the core drivers of growth under China's 'new economic cycle':**

  In terms of industrial structure and growth, there are three notable changes in these drivers:

  - Firstly, the services sector (i.e. the tertiary industry) has now become the foremost driver of growth in the Chinese economy, with its contribution to GDP growth having surpassed the 50% mark for the first time since the beginning of the 'reform and opening up' era to reach 52.9% in 2015 (Figure 19).

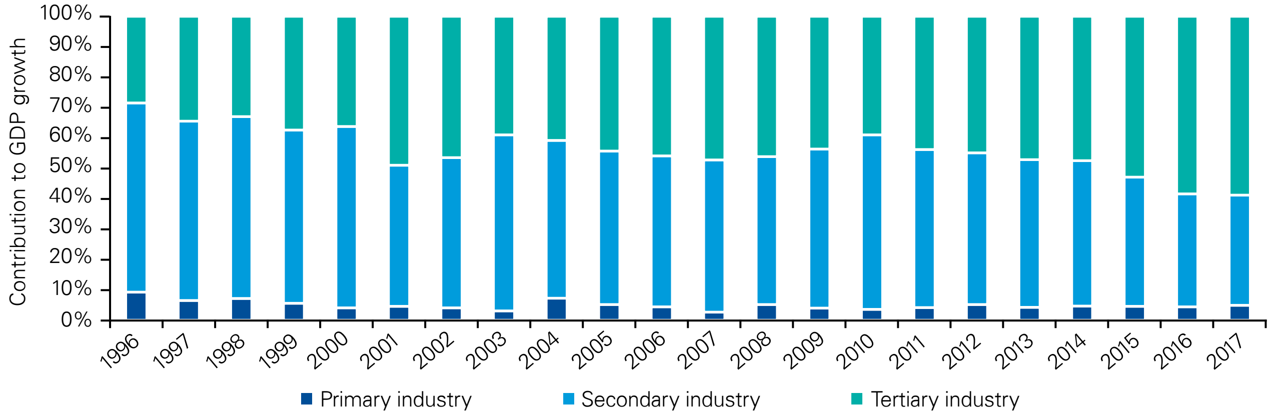
  - Secondly, the contribution of producer services to the overall services sector has increased substantially. Since 2011, and with the exception of 2016, the growth in value added from producer services has consistently outpaced the overall services sector (Figure 20). Going forward, the share of producer services in China's overall services sector is expected to continue expanding.[43]

  - Thirdly, the high-tech sector serves as an important driver of industrial growth. Since 2012, growth in value added from high-tech has consistently outpaced the manufacturing sector (Figure 21). Technology now also clearly outperforms the traditional manufacturing sector in terms of its contribution to total economic growth.

[42] 'Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era (Delivered by Xi Jinping at the 19th National Congress of the CPC)', Xinhua News, 18 October 2017, http://www.xinhuanet.com/english/download/Xi_Jinping's_report_at_19th_CPC_National_Congress.pdf

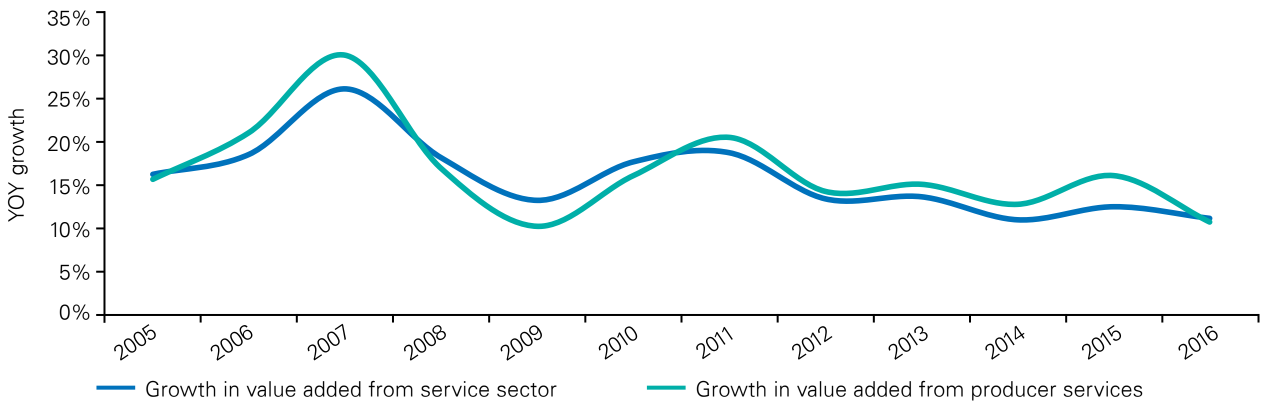
[43] Producer services refers to intermediary business services that facilitate production activities of other enterprises, primarily: transportation, logistics, warehousing, posts and telecommunications, finance, information transmission, computer services and software, and leasing and business services.
By bolstering the areas of weakness of China's economy, the share of value added from the service sector in the country's GDP is expected to maintain a steady upward trend in the following 10 years, and the share of value added from producer services in GDP will continue rising rapidly. This trend suggests that the share of producer services in China's overall service sector is expected to continue expanding. See: 'Report of Guotai Junan Securities: Value added from service sector expected to contribute 50.8 percent to GDP in 2016', Phoenix News, 26 February 2016, http://finance.ifeng.com/a/20160226/14237608_0.shtml

Figure 19: Contribution of the primary, secondary and tertiary industries to China's GDP growth[44]



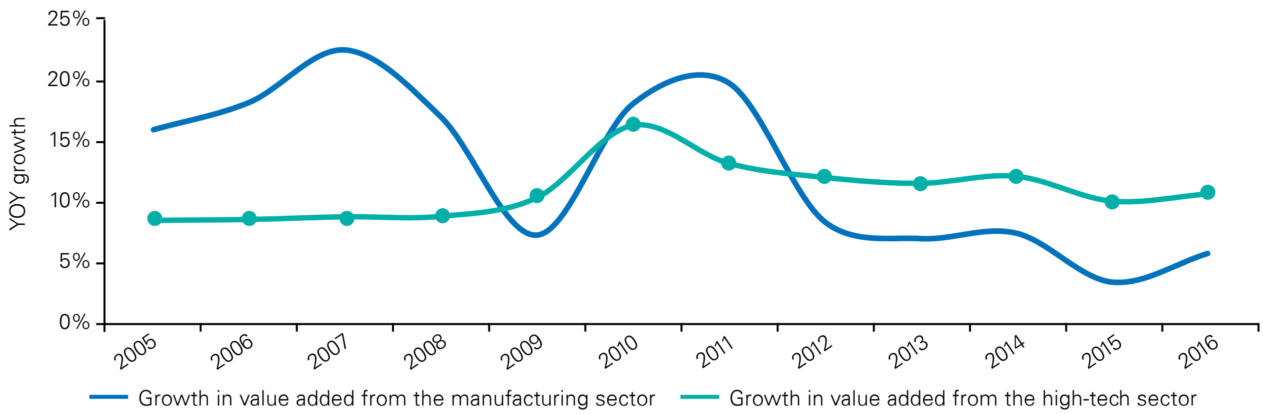
Source: National Bureau of Statistics of China; WIND

Figure 20: Growth rate in value added from producer services vs the overall service sector in China



Source: National Bureau of Statistics of China; WIND

Figure 21: Growth rate in value added from the manufacturing sector vs the high-tech sector in China



Source: National Bureau of Statistics of China; Ministry of Industry and Information Technology of the People's Republic of China; WIND

[44] According to the industry structure that the National Bureau of Statistics of China uses, the primary industry consists of agriculture (including farming, forestry, animal husbandry and fishery); the secondary industry includes mining and quarrying, manufacturing, production and supply of electricity, water and gas, as well as construction; and the tertiary industry includes the rest of the sectors, which provide various kinds of services for production and consumption. See '3. National Accounts', National Bureau of Statistics of China, 19 April 2002, http://www.stats.gov.cn/english/ClassificationsMethods/Definitions/200204/t20020419_72392.html

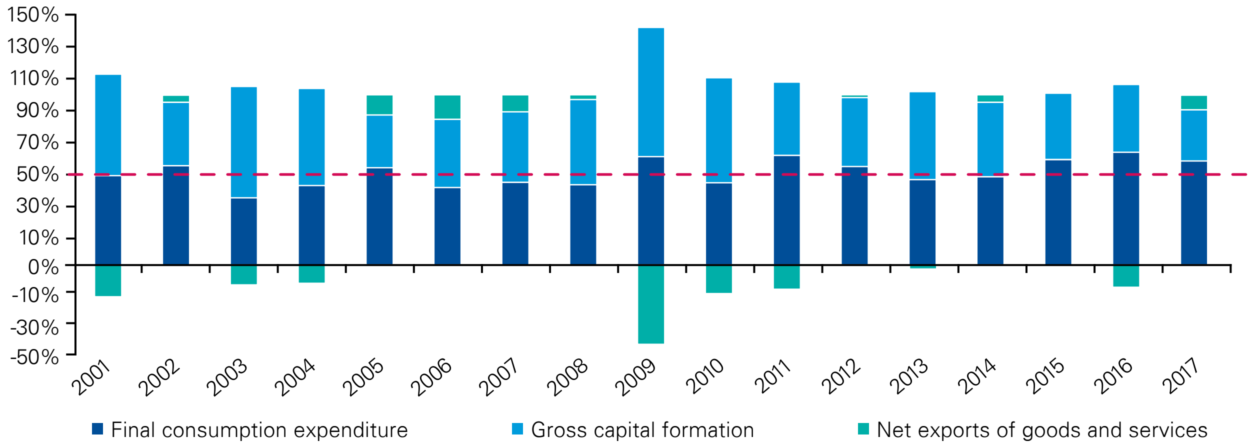
- **Internal demand – especially consumption demand – is emerging as the largest 'pull' factor in the Chinese economy:**

  A growing economy and rising household incomes are beginning to unlock the potential of China's internal demand.

  Based on official data, our calculations show that the average contribution of internal demand to overall growth increased by 11.14 percentage points in the eight-year period following the financial crisis (2009-2016) relative to the average contribution in the eight-year period following China's accession to the World Trade Organization (WTO) (2001-2008).[45] Conversely, the average contribution of external demand to overall growth decreased by 11.14 percentage points in 2009-2016 relative to the average contribution in 2001-2008.

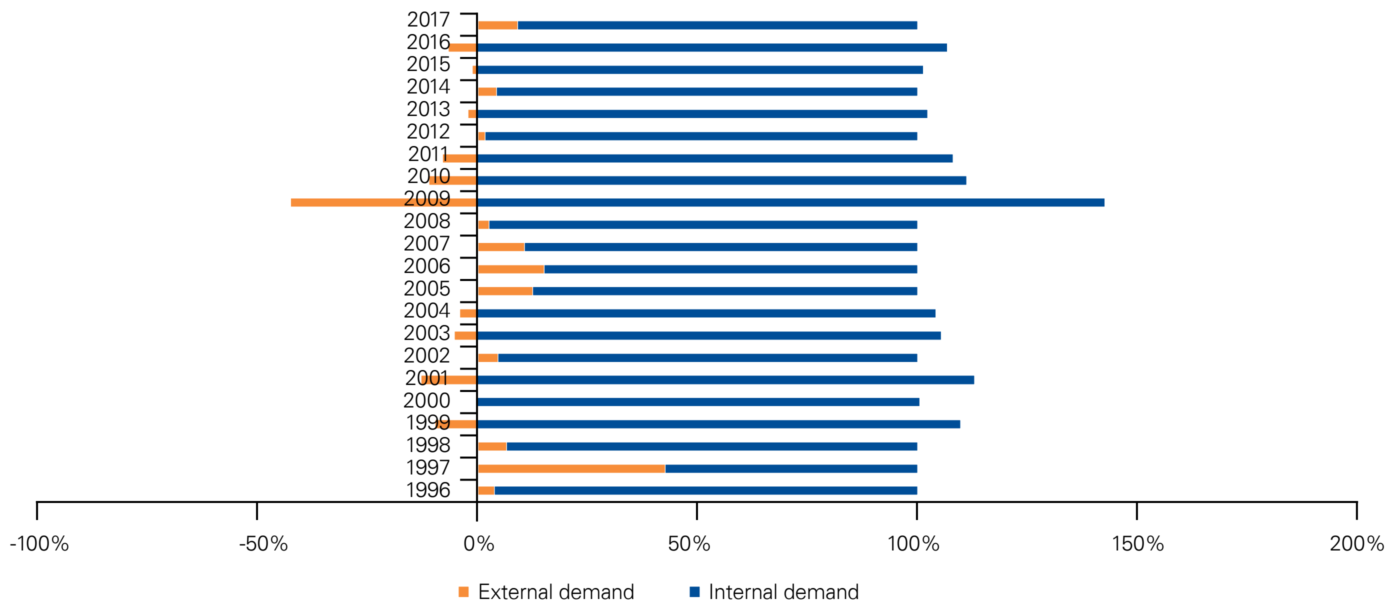
  Consumption demand has played a particularly strong role in this shift. In the years since 2011, and with the exception of 2013, consumption has exceeded investment in terms of its annual contribution to economic growth, accounting for 64.6% of growth in 2016, the highest level since 2001. Domestic consumption has become a true 'engine of growth' in the Chinese economy (Figure 22).

Figure 22: Contribution of consumption, investment and net exports to economic growth in China



Source: National Bureau of Statistics of China; WIND

Figure 23: Contribution of internal vs external demand to economic growth in China



Source: National Bureau of Statistics of China; WIND
Note: Contribution to growth from internal demand refers to the sum of contribution to growth from capital formation and final consumption expenditure. Contribution to growth from external demand refers to the contribution to growth from the net export of goods and services.

45 According to official data from China's National Bureau of Statistics, the average contribution of internal demand to China's GDP growth from 2001 to 2008 was 97.15%, while from 2009 to 2016 it was 108.29%. Therefore, the contribution of internal demand to the country's economic growth increased by 11.14 percentage points – i.e. 108.29 - 97.15 = 11.4. For its part, the average contribution of external demand to China's GDP growth from 2001 to 2008 was 2.85%, while from 2009 to 2016 it was -8.29%. As such, the contribution of external demand to the country's economic growth decreased by 11.14 percentage points – i.e. -8.29 - 2.85 = - 11.14. See Figure 23.

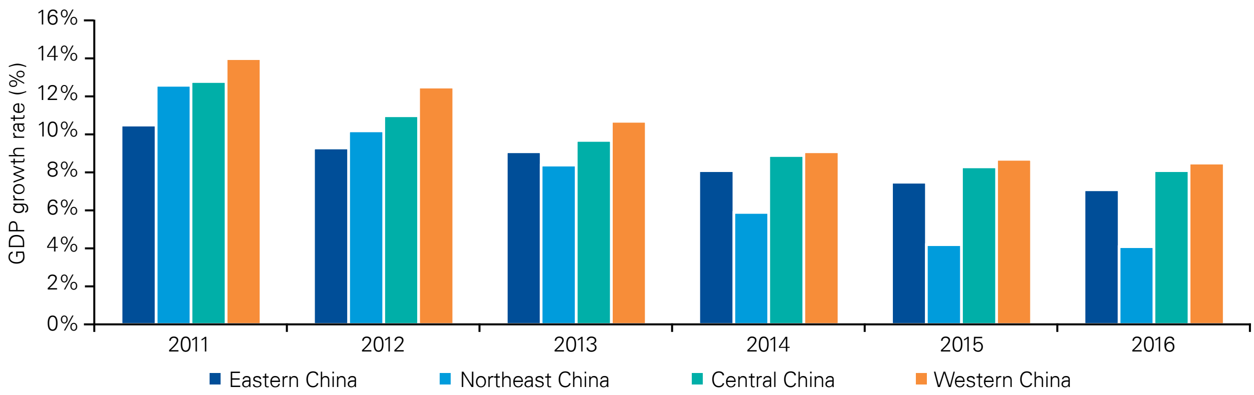
- **Development in Central and Western China and rural areas is 'supporting' growth:**

  Since the beginning of the 'reform and opening up', when the Chinese Government pursued a strategy of "first developing coastal regions to drive the development of inland regions",[46] the eastern provinces have always been the strongest growth points in the Chinese economy. However, China is now pursuing a more balanced regional development strategy; together with their increasingly apparent cost advantages, and the strong positive spillover effects from the east, the central and western regions are now emerging as the most economically dynamic regions in China.

  The growth rate of the central and western regions surpassed that of Eastern China in 2011, and remained the fastest growing of any region in China over the following five years, with rates far above the national average (Figure 24). In the first half of 2017, western provinces including Tibet, Chongqing and Guizhou led the nation in economic growth, with other central and western provinces such as Jiangxi, Anhui, Yunnan, Henan and Ningxia also ranking near the top nationally.[47]

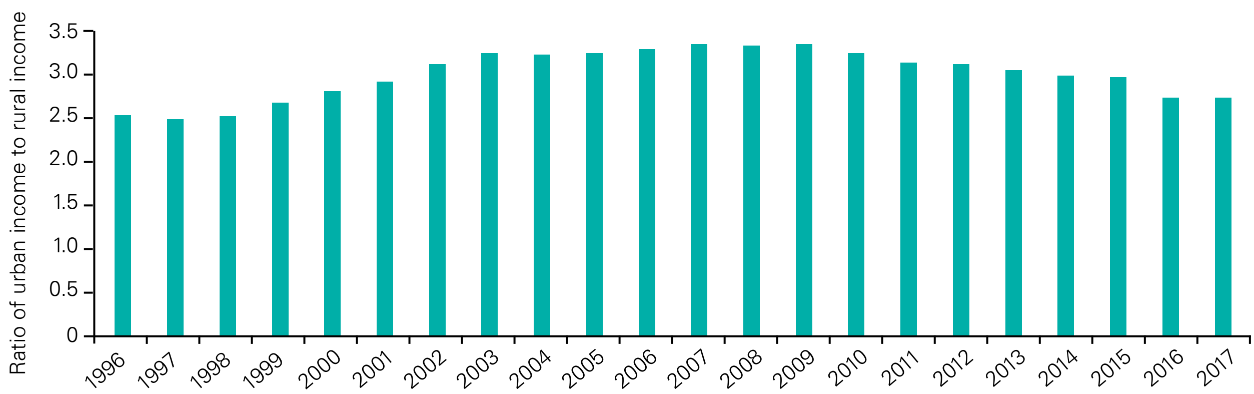
  Meanwhile, as China continues to advocate a policy of 'industry feeding back to agriculture',[48] and is pressing forward with reforms to rural economic systems, rural economic growth is picking up pace and urban-rural income gaps are shrinking (Figure 25). The potential of rural markets will be gradually realised, and the contribution of rural areas to China's economic growth will continue increasing.

Figure 24: Economic growth rates in Eastern, Central, Western and Northeast China



Source: Relevant reports from the National Development and Reform Commission (NDRC)

Figure 25: Urban and rural income ratio in China



Source: National Bureau of Statistics of China; WIND

Note: Urban and rural income ratio is expressed as per capita annual disposable income in urban households, divided by per capita annual gross income in rural households. Given that there is no available data for gross income in rural households for 2016 and 2017, we use annual disposable income in rural households as a substitute.

[46] 'Deng Xiaoping: The Central Committee of the Party and the Central Government must have authority', People's Daily, 24 October 2006, http://cpc.people.com.cn/GB/69112/69113/69684/69696/4950027.html

[47] 'Provincial and municipal GDP growth in H1 2017 released', People's Daily, 3 August 2017, http://politics.people.com.cn/n1/2017/0803/c1001-29448171.html

[48] 'Industry feeding back to agriculture' refers to the initial stages of a country's industrialisation, in which the agriculture sector provides food supply and raw materials to support the development of the industrial sector. When the economy reaches a certain level of industrialisation, the development of modern agricultural technology helps the agriculture sector increase productivity, food security and profitability.

In summary, as China's economy bottoms out, the structure and growth engines of the emerging 'new economic cycle' are different from those of the old one. To gain the most from this new cycle, foreign investors should understand the new features of this cycle and leverage that insight to optimise the sectoral make-up and regional deployment of their investments. Chinese companies should also correctly identify the structural and institutional changes that are underway, and position their outbound investments to support the transformation of the domestic economy. This will not only allow Chinese companies to expand their presence in international markets, but also further strengthen the domestic business that supports their growth and create positive linkages and greater integration between the businesses undertaken in domestic and overseas markets respectively.

3. China's 'new economic cycle' will boost the resilience of global growth

As China's economy expands, household incomes rise, and cross-border trade and investment flows continue to grow, the country's influence on the global economy has gradually become more pronounced, with the spillover effect of its economy and policies having an increasingly larger impact across countries. For this reason, we believe that the emergence of China's `new economic cycle' will inject new dynamism into a flagging world economy, making world economic growth more resilient, and having a positive effect on the pace of its recovery.

3.1 China's importance in the global economy has increased markedly

Over the past years, China has contributed around 30% to global growth, reaching 31.5% in 2016. This is the single largest contribution of any country, and more than the combined contribution to growth from the US, the eurozone and Japan in that same year (Figure 26). This confirms China's leading role in the world economy. The ongoing expansion and transformation of its economy will offer foreign companies even more opportunities to invest and participate in building the `new normal'. Chinese companies can also take advantage of the positive economic conditions at home to grow their business and make themselves stronger and more competitive. In this way, they will be able to continue `going out'. By `going out', these companies can acquire high-quality international assets to support the transformation of the domestic economy in China.

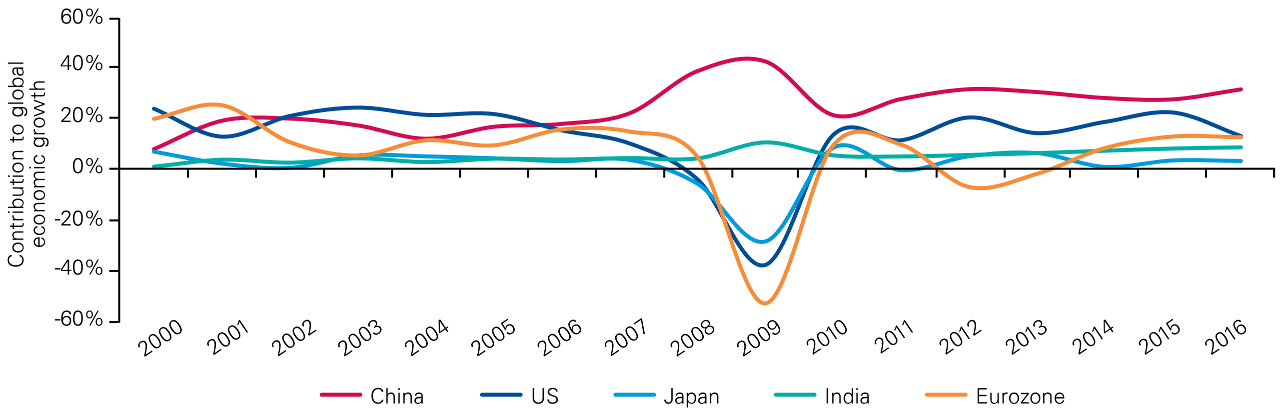
3.2 China's shift from a 'receiver' of global economic cycles to an 'initiator'

As mentioned above, China's economy and policies are having an increasingly significant spillover effect on the global economic landscape. This also means that China has become a key driver of global economic cycles.

In past years, the real economy – and foreign trade specifically – served as the primary channel for the spillover effects from China to the world.[50] According to data from the WTO, China has been the world's largest exporter and the second largest importer since 2009. In 2016, China's exports, imports and total trade volumes accounted for 13.15%, 9.78% and 11.45% of the global total respectively, making it the second largest trading nation in the world (Figure 27).

Further to this, as both FDI and outward direct investment (ODI) increase, and capital markets continue to open in both directions, finance is rapidly emerging as a second channel for Chinese spillover effects into the global economy. China's increased importance in the world economy and its spillover effects from trade and finance also magnify the impact of the country's fiscal, monetary and other macroeconomic policies on the world economy at large. This means that China is now evolving from a passive 'receiver' that is influenced by global economic cycles, to an 'initiator' that influences how those very cycles develop.

Figure 26: Contribution of major economies to global economic growth



Source: World Bank
Note: Calculated using the Atlas method[49]

[49] The Atlas method refers to the methodology used by the World Bank, which uses the Atlas conversion factor instead of simple exchange rates to convert gross national income (GNI – formerly referred to as GNP) to current US dollars when estimating the size of economies. The purpose of the Atlas method is to reduce the impact of exchange rate fluctuations in the cross-country comparison of national incomes. See: 'The World Bank Atlas method – Detailed methodology', The World Bank, accessed in February 2018, https://datahelpdesk.worldbank.org/knowledgebase/articles/378832-the-world-bank-atlas-method-detailed-methodology

[50] According to the IMF, China will impact other regions of the world economy through trade channels; as the Chinese economy rebalances, it will have an increasing influence and spillover effect on the global economy. See: 'People's Republic of China: Spillover Report for the 2011 Article IV Consultation and Selected Issues', IMF, July 2011, https://www.imf.org/external/pubs/ft/scr/2011/cr11193.pdf

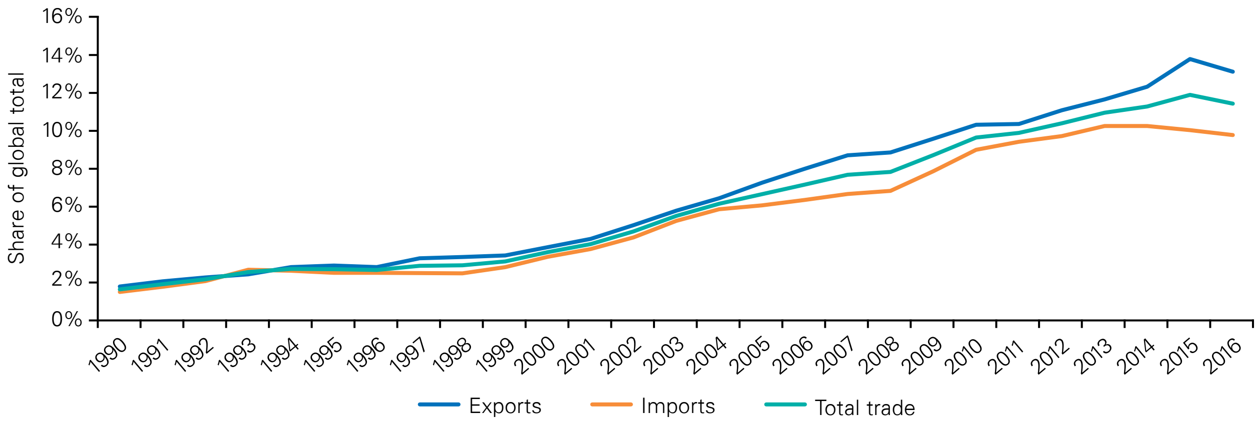
From this perspective, understanding what is happening in the Chinese economy should inform investment decision-making of foreign companies investing in China, as well as Chinese companies investing overseas. By understanding China's 'new economic cycle' and seizing the opportunities that arise, companies will be able to keep in step with and benefit from changes in the global economy, and realise sustained development over the long term.

3.3 China's 'new economic cycle' is set to drive the recovery of the global economy

Since the 2008 financial crisis, the global economy has experienced a decade-long period of depressed economic activity. Since 2012, global growth has consistently wavered below 4%, and appears unable to regain the relatively fast-paced growth above 4% that was typical of the pre-financial crisis period (Figure 28).

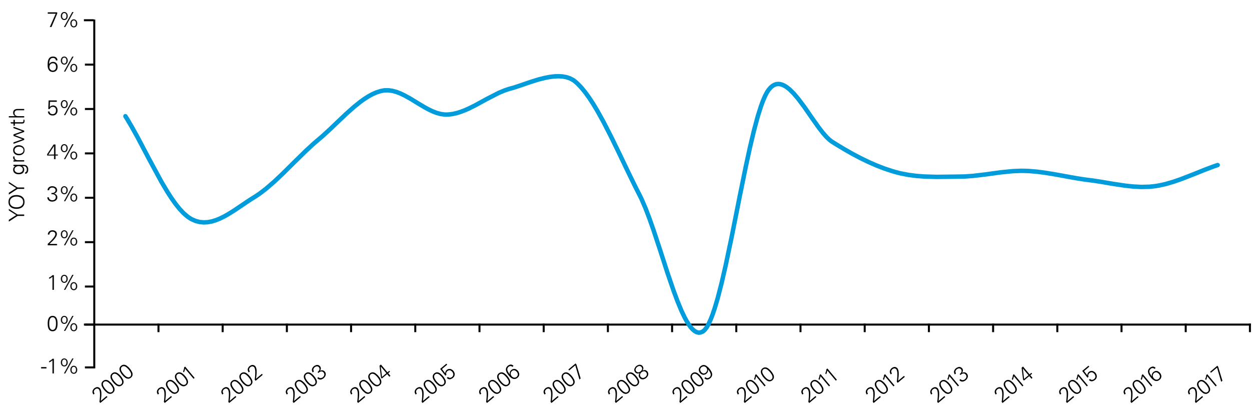
Given that China has been the greatest single contributor to global growth since the crisis, it is clear that the lagging global recovery and China's own slowdown were related; indeed, the two had a mutually reinforcing effect. This also means, however, that as China's economy enters a new cycle, it has the potential to pull the world economy out of subpar growth and drive a sustained global recovery. Global investment, long stifled by the 2008 crisis, is gradually recovering, and a new round of globalisation looks set to gradually take hold. These are very favourable developments for Chinese and foreign investors.

Figure 27: Chinese exports, imports and total trade as a proportion of the global total



Source: World Trade Organization
Note: Calculated using the Atlas method

Figure 28: Global economic growth rate



Source: IMF World Economic Outlook Database

4. Implementation of the 'Belt and Road' Initiative advances the 'new paradigm of globalisation'

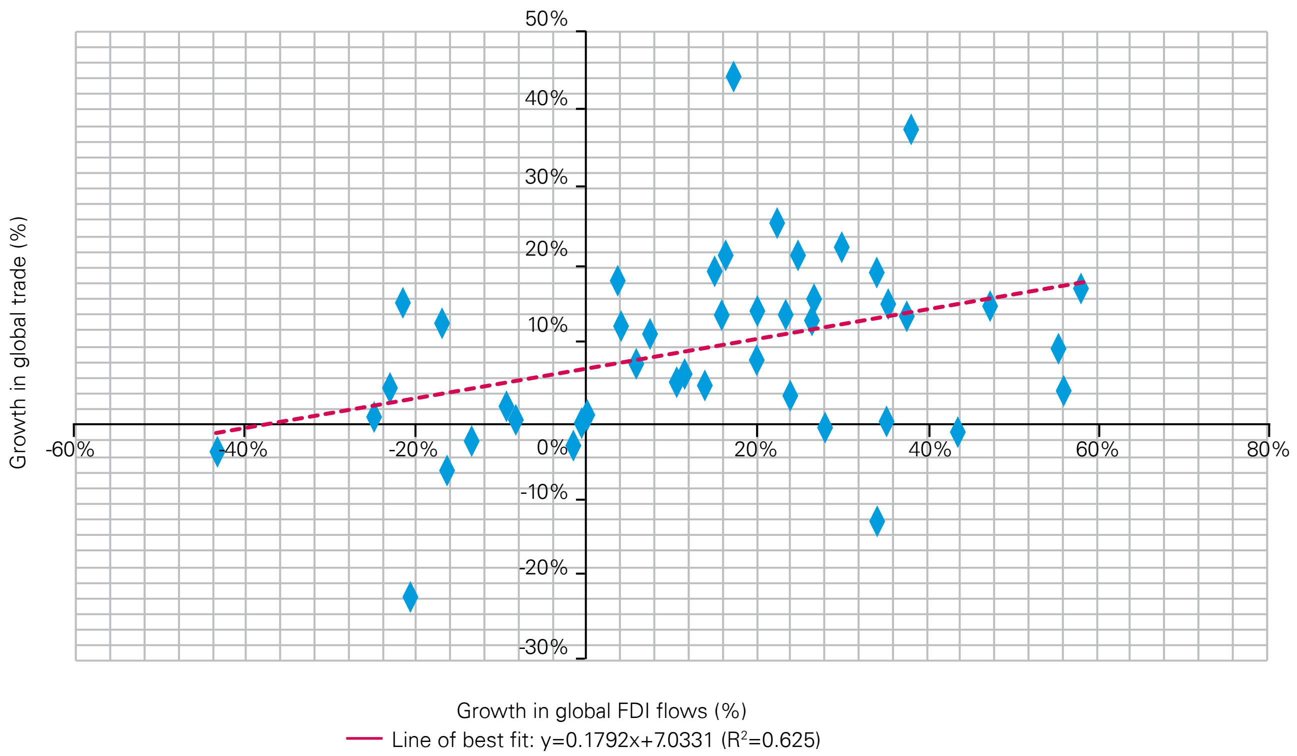
On 17 January 2017, President Xi Jinping delivered a keynote speech at the opening plenary of the World Economic Forum Annual Meeting in Davos.[51] The speech responded to the challenges of 'anti-globalisation' with a call for the BRI to usher in a new phase of globalisation, thereby offering a 'Chinese solution' to the growing economic disparities around the world. With steady progress being made to implement the BRI, the 'new paradigm of globalisation' proposed by the Chinese Government stands to inject new vitality into the world economy, and lay an important foundation for a resurgence in global investment and trade.

4.1 Globalisation drove half a century of cross-border trade and investment prosperity

The most recent wave of globalisation took place between the 1970s and the 2008 financial crisis, a time during which global growth remained relatively stable. The growth in FDI flows, trade and the economy at large were closely correlated during this period, indicating that global investment is an important accelerator of trade and that the two combined are the core drivers of growth in the greater global economy (Figures 29-31). The last round of globalisation, therefore, was an important factor in the nearly 50 years of flourishing cross-border investment and trade, as well as sustained global economic development. Any 'anti-globalisation' movements or mindsets are therefore a threat to cross-border trade and investment, and to the recovery and growth of the world economy.

Taking active steps to advance globalisation and encourage cross-border investment by Chinese and foreign companies will help pull the world economy back on track, and in turn, lead to more opportunities for cross-border investment and fewer risks associated with undertaking these investments.

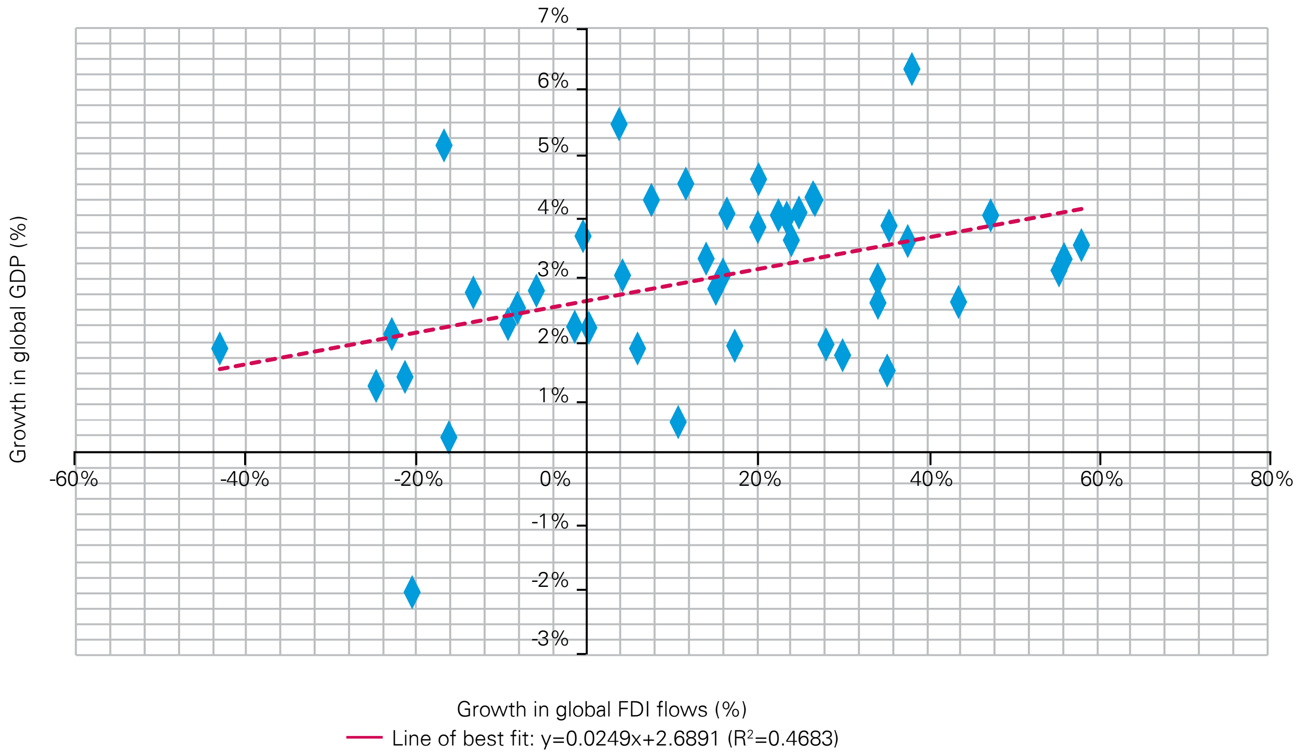
Figure 29: Correlation between growth in global trade and FDI flows (1971-2016)



Source: WTO; United Nations Conference on Trade and Development (UNCTAD)

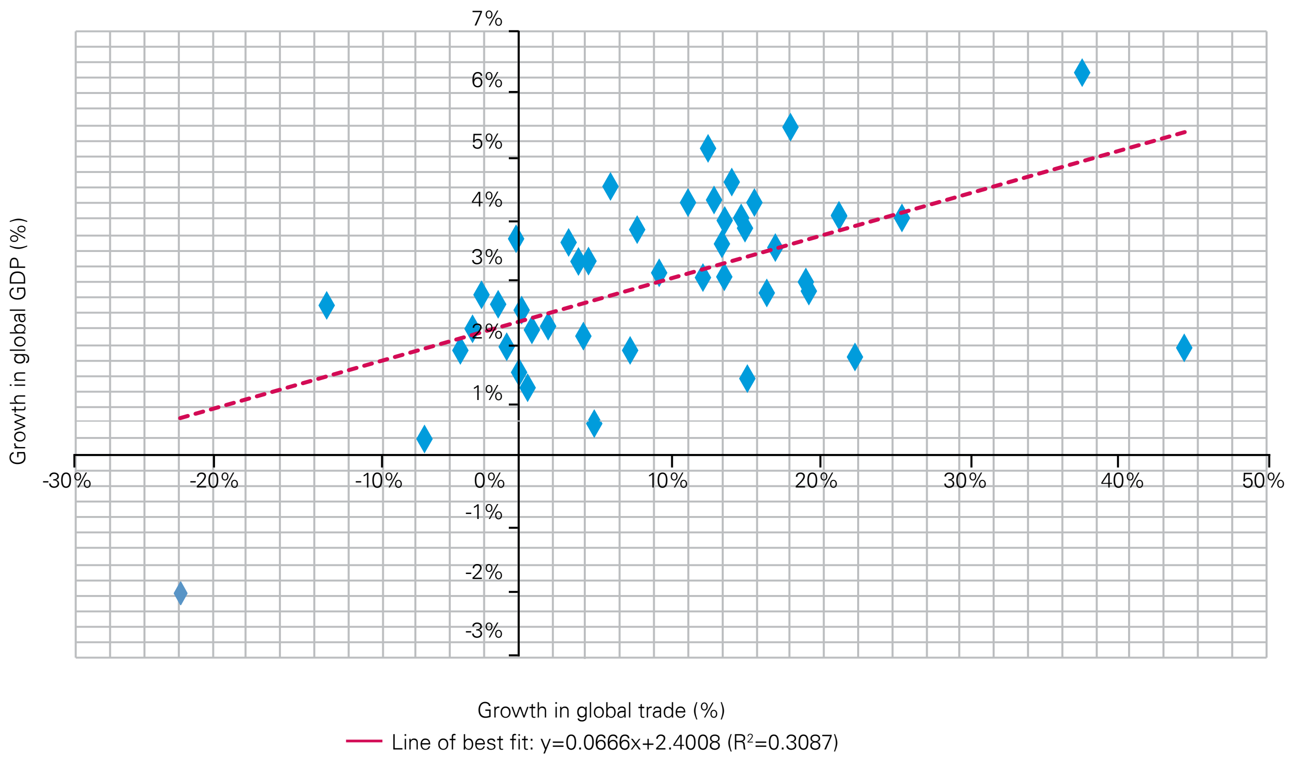
[51] 'Jointly Shoulder Responsibility of Our Times, Promote Global Growth (Keynote Speech by Chinese President Xi Jinping At the Opening Session Of the World Economic Forum Annual Meeting 2017)', The State Council Information Office, 17 January 2017, http://www.china.org.cn/node_7247529/content_40569136.htm

Figure 30: Correlation between growth in global GDP and FDI flows (1971-2016)



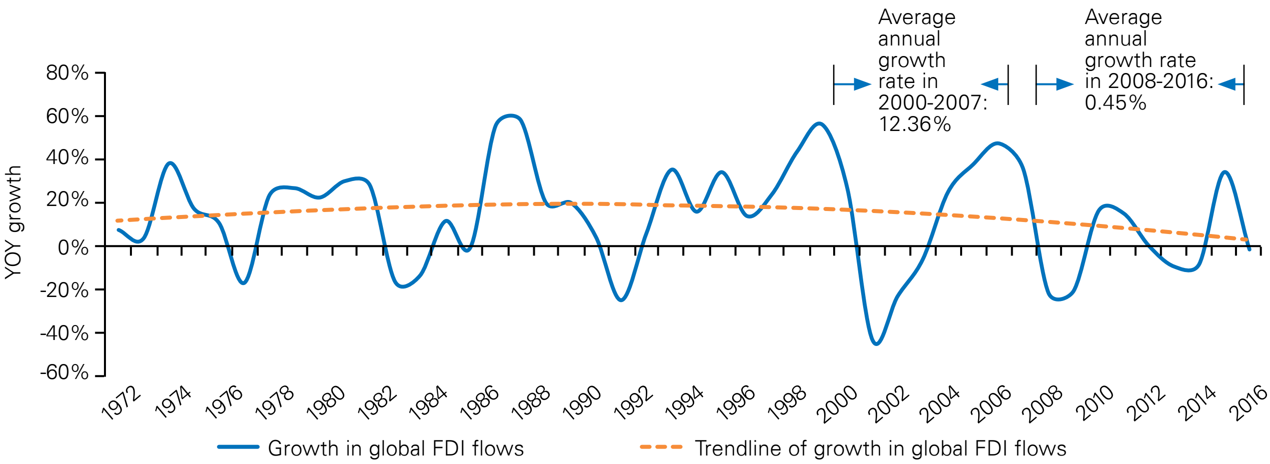
Source: WTO; UNCTAD

Figure 31: Correlation between growth in global GDP and trade (1971-2016)



Source: WTO; UNCTAD

Figure 32: Growth in global FDI flows



Source: UNCTAD

4.2 Recent years saw slowdowns in cross-border investment

Since the 2008 financial crisis, growth in cross-border investment flows has been dragged down considerably by weak global recovery, sluggish demand, a slowdown in some commodity export-oriented economies, and sharp declines in revenues of some multinational companies. Based on data from UNCTAD, for instance, our calculations show that global FDI flows grew at an average annual growth rate of 12.36% between 2000 and 2007, while between 2008 and 2016 they grew at an average of just 0.45% (Figure 32).

The rise of anti-globalisation movements in recent years has only put additional downward pressure on cross-border investment flows. Chinese and foreign companies have encountered many obstacles when making decisions about investing and operating overseas, and identifying partners for these activities. The performance of multinationals' overseas businesses has also been affected, with profitability on a steady decline since 2010. While 2016 saw some improvement in overseas business performance,[52] the foundations of this recovery remain shaky, and there may be relapses due to fluctuations in the global economy or shifts in the global investment climate.

4.3 It will be difficult for the traditional model of globalisation to lead the world out of the post-crisis era

The global value chain that supported the wave of globalisation that began in the 1970s had these characteristics: resource-oriented economies would export raw materials and import relatively low-end finished goods; processing-oriented economies would import the raw materials and intermediary products, and export finished goods; and capital-oriented economies (consumer societies) would export core intermediary products and import high-end consumer goods. This traditional model of globalisation led to economic and trade imbalances around the world, with excessive rates of consumption in some countries and excessive rates of saving in others. Large account surpluses and deficits between these countries also emerged. This imbalance at the heart of the traditional model of globalisation was actually one of the underlying causes of the 2008 financial crisis.[53]

In the period since the 2008 financial crisis, nations around the world have come to realise that recovery in the global economy will be difficult to achieve given the inherent imbalances in this traditional model of the global value chain. It has been difficult, however, to find an effective means of promoting global trade so as to bring about a recovery in the world economy. Global trade growth has slowed steadily in recent years, even falling below global economic growth (Figure 33). This has made it challenging for Chinese and foreign companies to find new sectors and geographic regions to invest in to grow their international business.

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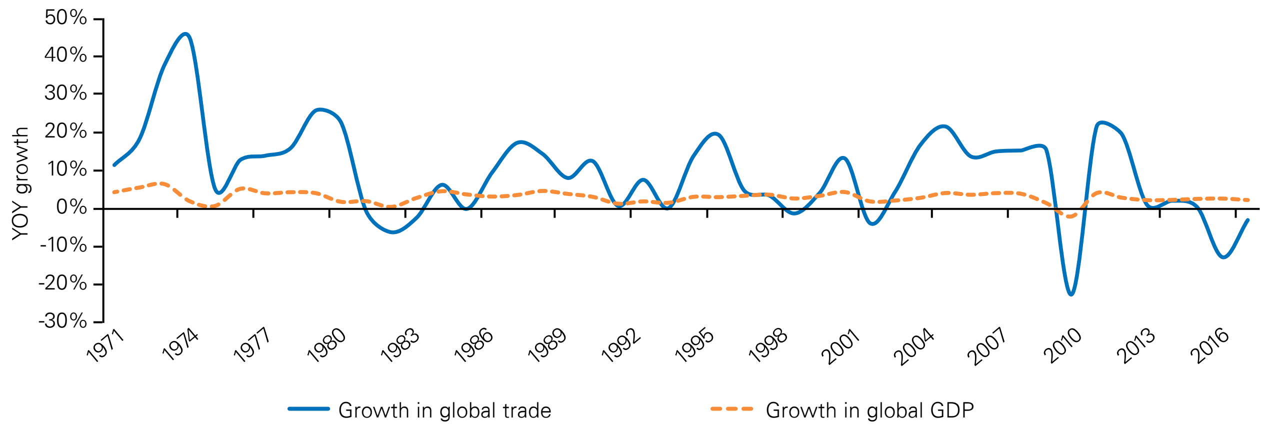
[52] According to the 2017 edition of UNCTAD's *World Investment Report*, profits and profitability of MNCs declined between 2008 and 2015. However, the improvement of the global economic outlook and a rise in prices in 2016 significantly boosted the profit and profitability of MNCs. See: 'World Investment Report 2017', UNCTAD, June 2017, http://unctad.org/en/PublicationsLibrary/wir2017_en.pdf

[53] Rising global imbalances are associated with a greater dispersion of current account positions across countries and larger net flows of capital between countries. At the level of an individual country, a current account deficit is matched by net capital inflows, as foreign investors build up claims on the domestic economy. High capital inflows in turn (i) can reduce the cost of wholesale funding for domestic banks in international markets; (ii) may reduce long-term interest rates (and thus compress spreads), causing financial institutions to lever up and investors to 'search for yield'; and (iii) may increase the total supply of credit to the domestic economy, causing local asset (house) prices to rise.

For more information, see: 'What caused the global financial crisis? – Evidence on the drivers of financial imbalances 1999-2007', Ouarda Merrouche and Erlend Nier, IMF Working Paper, December 2010, https://www.imf.org/external/pubs/ft/wp/2010/wp10265.pdf

Figure 33: Growth in global trade and the global economy



Source: WTO; UNCTAD

4.4 Implementation of the 'Belt and Road' Initiative will drive the emergence of a 'new paradigm of globalisation'

While visiting Kazakhstan and Indonesia in the autumn of 2013, President Xi Jinping proposed the development of the 'Silk Road Economic Belt' and the '21st Century Maritime Silk Road', which are collectively known as the 'Belt and Road' Initiative. The initiative seeks to promote policy coordination, infrastructure connectivity, unimpeded trade, financial integration and people-to-people exchanges, in order to deepen political trust, further economic integration, and create a community of common interest, common responsibility and common destiny.

The BRI promotes the redistribution of global wealth, bringing marginalised developing nations and emerging economies into the heart of globalisation. It seeks to develop new areas of the global economy and share the benefits of globalisation with more countries along the 'Belt and Road', thereby addressing the shortcomings and inherent contradictions of the traditional model of globalisation.

The area covered by the BRI encompasses a population of 4.4 billion people, or 62.55% of the world's population, and represents almost 30% of global GDP.[54] It is designed to promote an innovative approach towards global investment and trade, and sustainable development. The objective is for the 'new paradigm of globalisation' that emerges to be open, inclusive, balanced and beneficial to all (Table 2). This has the potential to greatly expand the field for global investment and unlock the market potential of developing nations and emerging economies, creating a positive economic climate for a resurgence in global cross-border investment.

[54] 'Belt and Road Initiative has the potential to reinvent globalisation', Xinhuanet, 31 July 2017, http://news.xinhuanet.com/silkroad/2017-07/31/c_129668458.htm

Table 2: Traditional model vs the 'new paradigm of globalisation'[55]

Model / Aspect	Traditional model[56]	New paradigm
Participants in globalisation	Developed nations and some emerging market nations	Developed nations, emerging market nations and developing nations
Leadership	Led by major developed nations	Led jointly by all participants
Global governance structure	After World War II, the world order was led by a few nations, which established the institutions and rules. All other nations were relatively passive receivers of these governance structures	All nations discuss and work together to build governance institutions and rules that benefit all
Specialisation	Division of labour between resource-, manufacturing- and capital (consumption)-oriented economies	A more complex and inclusive network of all nations that wish to participate in global free trade and investment
Trade	Global trade is unbalanced, with large deficits and surpluses concentrated in a few economies	Global trade is more balanced, with relatively even distribution of surpluses and deficits between major economies
Cross-border investment flows	Investment flows primarily from developed nations towards emerging market nations and between developed nations	The flow of global capital is balanced, and spread among more participants, with investments made between developed nations; between emerging market nations; from developed nations to emerging market and developing nations; and from emerging market nations to developed and developing nations
Cross-border investment vehicles	Sovereign wealth funds, development finance, and private capital invest independently and separately	Cooperation between sovereign wealth funds, development finance and private capital to achieve synergies
Distribution of profits	Globalisation is not inclusive and its benefits are unevenly distributed, with profits flowing primarily to capital- (consumption-) oriented economies, and to the groups that control the political and economic power in resource-oriented economies	Globalisation is more inclusive and its benefits are equally enjoyed by all, with profits distributed more evenly between nations and between classes within nations

Sources: Summary by KPMG China based on President Xi Jinping's speech at the 2017 World Economic Forum Annual Meeting in Davos, as well as relevant statements by the Chinese leadership since then.

55 The 'new paradigm of globalisation' was first proposed by President Xi Jinping at the 2017 World Economic Forum Annual Meeting in Davos. KPMG China has compared the characteristics of the traditional model of globalisation with those of the 'new paradigm of globalisation' based on President Xi's speech and relevant statements by the Chinese leadership since then. Table 2 highlights the result of this analysis.

56 The contents represent the Chinese view of the traditional model of globalisation.

5. New investment opportunities come with risks

The nascent phase of China's 'new economic cycle' and the lead-up to a 'new paradigm of globalisation' offer strategic opportunities for foreign companies to accelerate their investments in China and for Chinese companies to make progress with efforts to 'go out'. That said, because the 'new economic cycle' and 'new paradigm of globalisation' are still in their infancy, there are still some uncertainties that could pose risks to cross-border investment. When planning their future global investments, Chinese and foreign companies should carefully weigh the real opportunities brought by the 'new economic cycle' and 'new paradigm of globalisation' against the risks that may be present during the initial phase of their development.

5.1 The initial phase of a 'new economic cycle' is often the best time to test new investment approaches

China's 'new economic cycle' and the 'new paradigm of globalisation' signify the beginning of a new phase of economic development. This is an ideal time for companies to invest and expand their operations.

During this early phase, most companies tend to adopt a relatively conservative approach. This results in fewer competitors and less competition in the market. These conditions mean that if more proactive companies are able to achieve scale rapidly, when the 'new economic cycle' starts, these companies may be able to gain a first-mover advantage, and enjoy a competitive edge over companies that took a 'wait-and-see' approach.

This phase also represents a period of market recovery as new demand emerges and gradually takes off. Companies that invest and grow during this time can not only expand in their traditional markets, but also enter new markets quickly, capturing more market share at a relatively low cost, and laying the foundations for further investment later in the economic cycle.

Additionally, the starting phase of a 'new economic cycle' is often accompanied by the creation and development of many emerging industries, giving companies an ideal opportunity to enter new fields and establish a first-mover advantage. By investing in new industries and new business models, companies may be able to develop unique advantages and create the potential for earning monopoly profits.

For these reasons, in the period leading up to the official start of China's 'new economic cycle' and the emergence of the 'new paradigm of globalisation', Chinese and foreign companies should push forward the development of their international operations to stay a step ahead of global markets and prepare for the next phase of faster corporate growth.

5.2 The initial phase of a 'new economic cycle' is also often the most risky time for investment

While the trends pointing to the emergence of China's 'new economic cycle' and the 'new paradigm of globalisation' are increasingly visible, at this early stage there are still considerable uncertainties and risks for companies to grow their international business.

First, as China enters the 'new economic cycle', it is possible that its recovery will experience relapses. Progress of the 'new paradigm of globalisation', for its part, may be impeded by anti-globalisation sentiment and measures. These uncertainties pose a serious risk to first-mover investors, whose early investments may end up having to be written off as sunk costs.

Next, while new industrial and regional development are beginning to take shape, there are still unknowns and a number of variables that could add uncertainty to companies' decisions about whether to invest in a particular industry or region. As always, hasty investment can lead to substantial loss.

To add to this, providers of capital may tend to be risk-averse during the early stages of a 'new economic cycle', thereby increasing the financing costs for new investment. If the new cycle takes too long to get fully under way, it may delay cash flows and create financial risks for investors.

Therefore, while China's 'new economic cycle' and the 'new paradigm of globalisation' are still in their nascent phases, companies seeking to grow their international business should be cognisant of risks on a number of levels, and establish effective risk management and mitigation mechanisms to ensure they can expand and operate safely in overseas markets.

5.3 Prudent planning of new investments around the world in the context of China's 'new economic cycle' and the 'new paradigm of globalisation'

As China's 'new economic cycle' and the 'new paradigm of globalisation' approach, companies looking to increase their international investments and operations should actively pursue opportunities while managing risks. Companies should consider the following five points when deciding how to optimise and grow their international business in this environment:

i. **Move at the right pace:** Foreign companies investing in China should follow and analyse the stages and progress of China's recovery to avoid risks associated with operating in a fluctuating economy. Chinese companies looking to invest overseas should understand the steps and stages that will define the 'new paradigm of globalisation' to avoid the international business suffering losses as a result of operating in an anti-globalisation environment.

ii. **Identify the right industries:** Both foreign companies investing in China and Chinese companies investing overseas need to anticipate logical trends in the transformation of traditional industries and the patterns of development in emerging industries when looking for opportunities derived from the 'new economic cycle' and the 'new paradigm of globalisation'. Prudent decision-making can yield valuable first-mover advantages, while strictly managing and limiting potential risks.

iii. **Invest in the right regions:** Foreign investors should anticipate the pattern of regional development in China during the 'new economic cycle'. Chinese outbound investors need to take a view on new trends in the global economic situation. These perspectives can help all businesses avoid losses incurred by investing in the wrong locations.

iv. **Work with the right partners:** Foreign companies should explore new models for cooperating with Chinese state-owned and privately owned enterprises during the 'new economic cycle'. Chinese companies should work with multinationals to expand their business in China, in the multinationals' home countries, as well as in third-country markets. Collaboration between Chinese and foreign companies helps localise investments, and increases each party's awareness of and ability to manage and mitigate risks.

v. **Control risks effectively:** All companies should systematically analyse critical risks associated with their international business operations during this period, including from a strategic, financial and policy perspective. Implementing risk control systems and working with the right partners can help limit risks associated with investing and operating, and effectively mitigate pre-existing business risks.


STRATEGY
GOALS
RESEARCH

Chapter 2

Readjusting FDI: From seeking resource cost efficiency to a strategic market approach

China has become one of the most important destinations for foreign investment flows in the world, consistently ranking among the top five FDI host economies over the past years according to the World Investment Report published by UNCTAD. In 2017, China ranked as the number three destination for FDI, behind the US and UK.[57]

Having experienced a sharp drop in 2016, foreign investment flows into China rebounded in 2017, achieving YOY growth of 4.0%. We expect this upward trend to continue as China transitions to a 'new economic cycle', with continuous improvement in the quality and structure of FDI and an evolution in the advantages that China offers to foreign investment. Eventually, we believe FDI will reach and maintain a medium-high growth rate.

To win more and better business opportunities in China's 'new economic cycle', foreign investors need to understand and adapt to these new trends, adjust their mindset and update their investment strategy.

1. Key reasons underlining the positive prospects for China's inward foreign direct investment

Despite experiencing a relative growth slowdown over the past years, given the sheer size of its economy, China still has a tremendous demand for investment. Furthermore, China's economic transformation process is increasing the demand for high-quality investment, in turn enhancing China's capacity to absorb foreign capital, and creating important opportunities for foreign investors.

Consequently, we expect the Chinese Government to continue working to promote an open and business-friendly environment for FDI. While there may be some manifestation of accumulated macroeconomic risks, we believe these risks are, on the whole, controllable.

[57] 'World Investment Report 2017', UNCTAD, June 2017, http://unctad.org/en/PublicationsLibrary/wir2017_en.pdf

1.1 *A medium-high growth rate in an economy the size of China's 'underwrites' demand for investment*

China has experienced a marked declining growth trend in its inward foreign investment flows over the past years (Figure 34), with the growth rate even having dipped below zero in 2016 and in several months during 2017. While the decrease in the growth rate can be partly explained by a 'base effect', foreign investors have also formed bearish forecasts on China's prospects as a result of its growth slowdown, resulting in lower investment levels. The slowdown in the growth of China's FDI flows is also correlated with a drop in global cross-border investment flows.

Despite this, as China's economy is so large, maintaining a 'medium-to-high' growth rate provides ample room for foreign investment to grow. Not only is China's GDP growth rate among the highest in the world, but with an economy of over RMB 80 trillion (USD 11.84 trillion),[58] every percentage point of growth that China experiences today is equivalent in value to 1.5 percentage points five years ago or 2.5 percentage points 10 years ago.[59] To put these figures into context, consider that the 6.9% growth that China experienced in 2017 delivered an incremental economic output of more than RMB 8 trillion (USD 1.18 trillion)[60] (Figure 35), which is larger than the total GDP of Turkey.[61]

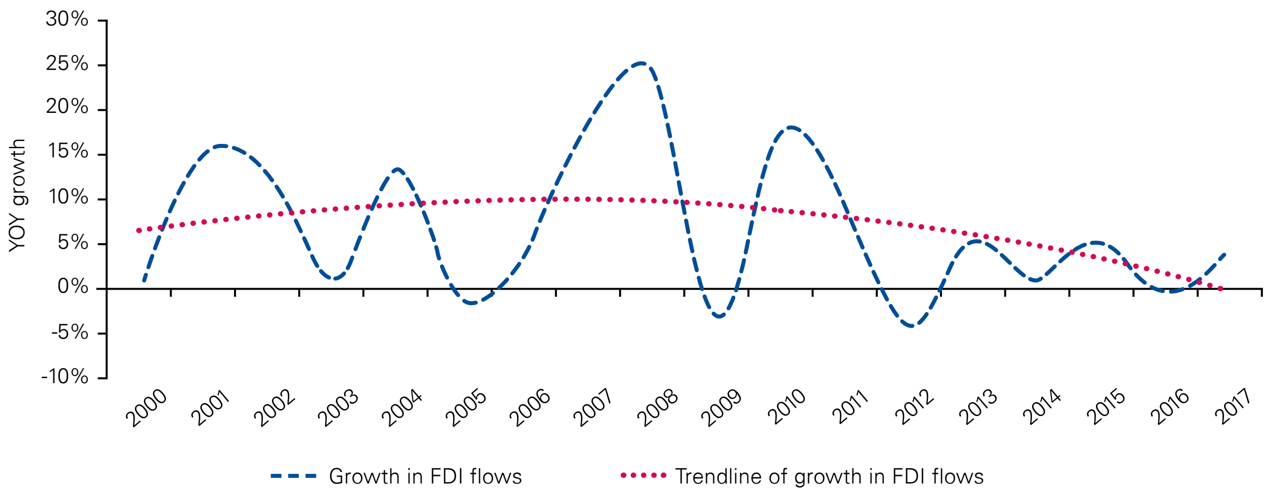
Given what one percentage point of growth represents for China, it is not surprising that its yearly growth in fixed asset investment is kept at a relatively high level, around RMB 3.5 trillion (USD 518.52 billion) (Figure 36). This means that as long as China's GDP maintains some degree of growth, there will be an ongoing demand for a relatively high level of fixed asset investment, an indispensable part of which will come from FDI.

It is also important to note that, when looking at historical data, China's FDI growth is inherently volatile. In 2017, for instance, even though China's FDI experienced weak to negative monthly YOY growth during the first seven months of 2017, growth rebounded in August and followed an upward trend until November when it grew by 90.0% YOY, then growth dropped again in December. This brought total FDI growth for the year to 4%.[62]

As China gradually enters a 'new economic cycle', the slowdown in FDI growth is likely to be halted and reversed, eventually maintaining a medium-high rate of growth. Certainly, due to the large base numbers involved, FDI is unlikely to post single-year growth rates of 20% or higher as it did in some past years.

Overall, we believe that the conditions exist for FDI to stabilise and rebound. Foreign companies should take a rational view of the underlying causes of the slowdown in FDI and in the Chinese economy more generally.

Figure 34: FDI growth in China



Source: Ministry of Commerce of China

[58] RMB to USD conversions calculated on the average exchange rate in 2017

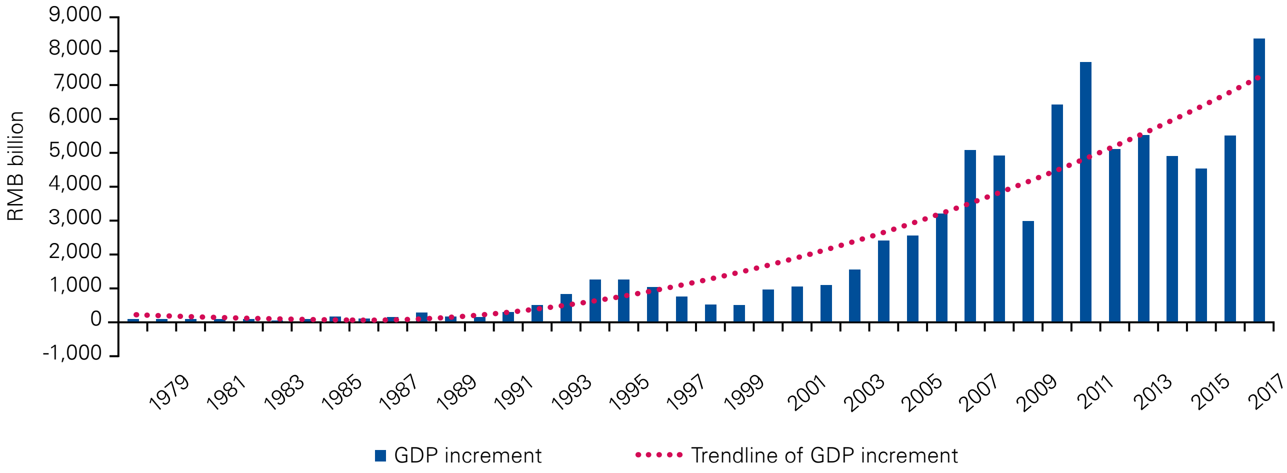
[59] 'Report on the Work of the Government (Delivered at the Fourth Session of the 12th National People's Congress of the People's Republic of China on March 5, 2016)', Xinhua News, 17 March 2016, http://www.xinhuanet.com/english/china/2016-03/17/c_135198880.htm

[60] RMB to USD conversions calculated on the average exchange rate in 2017

[61] According to data from UNCTAD, the GDP of Turkey in 2016 was roughly USD 710.7 billion.

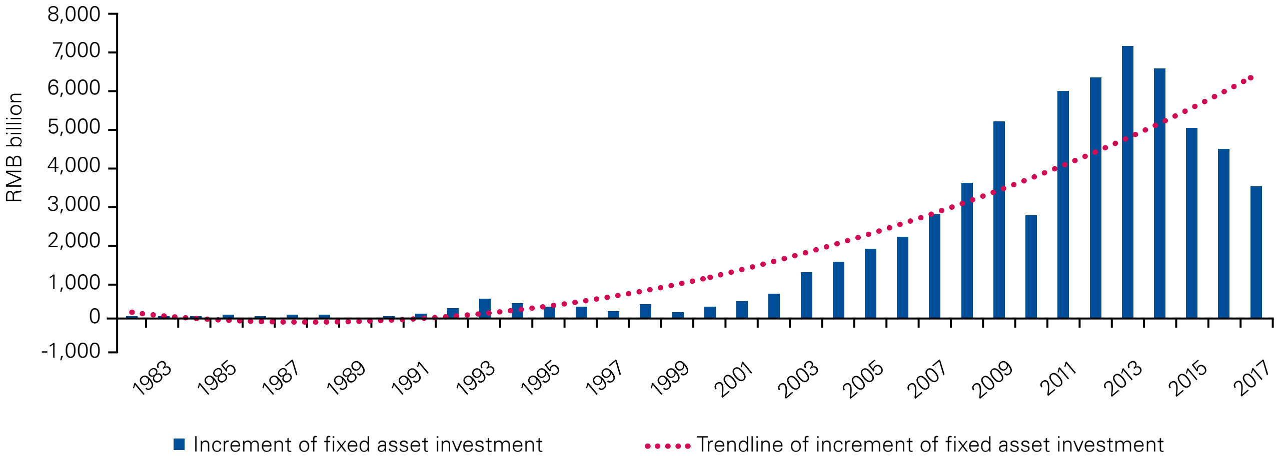
[62] The FDI growth rates provided by the Ministry of Commerce are calculated based on USD figures. See: 'Business Data Center of the Ministry of Commerce', Ministry of Commerce of the People's Republic of China, accessed on 30 January 2018, http://data.mofcom.gov.cn/index.shtml

Figure 35: Yearly increment in China's GDP



Source: National Bureau of Statistics of China

Figure 36: Yearly increment in fixed asset investment in China



Source: National Bureau of Statistics of China

1.2 More FDI is needed to support China's economic transformation under the 'new normal'

China's economic slowdown over the past several years, a sustained recession in traditional industries, and the erosion of China's cost advantages in factors of production have all contributed to a significant deceleration of FDI growth, with the share of FDI in total fixed asset investment in steady decline (Figure 37). As described above, however, these trends are generally cyclical, and as China's economy gradually recovers and stabilises, the deceleration of FDI growth will be managed effectively.

Even more importantly, the Chinese economy has entered a 'new normal' marked by the ongoing shifts in its structure, pace of development and growth drivers. In response to these shifts, foreign companies are going through a 'transition period' as they adapt to this 'new normal', change their investment philosophy and adjust their investment plans for the Chinese market. This is why most foreign companies are still maintaining a relatively conservative, 'wait-and-see' approach to investing in China.

The EU Chamber of Commerce in China's (EUCCC) *Business Confidence Survey 2017* indicates that 71% of European companies surveyed registered pre-tax profits in the 2016 fiscal year, but lacked confidence in the sustainability of profit growth.[63] For its part, the *China Business Climate Survey Report 2018* from the American Chamber of Commerce in China revealed that 59% of member companies ranked China as one of their top three investment destinations, while 33% of companies planned to expand their investments in the country by more than 10%. While these figures represent an improvement from the 2017 edition of the same survey, they are still down from previous years, such as in 2012, when the percentages were 78% and 54% respectively.[64]

As China's 'new economic cycle' gathers momentum, and especially as the country's ongoing economic transformation makes further progress, there will be an increased need for foreign investment in terms of capital, advanced technologies, managerial expertise and high-quality products to facilitate the country's industrial upgrading; satisfy the evolving demands of Chinese consumers; and support China's transition into an innovation-intensive, consumption-led economy. This is why we believe that FDI is a key enabler of China's economic transformation.

For this reason, compared to the period following the 2008 global financial crisis, the 'new economic cycle' will likely bring more investment opportunities for foreign companies and the potential to derive even more gains from these investments.

1.3 The Chinese Government understands and supports the key role that FDI can play in enabling China's economic transformation

The 13th Five-Year Plan calls for China to bring about a new stage of 'all-around opening up'. In terms of FDI, this means increasing access to new sectors, easing restrictions to market entry, creating a positive business environment and improving the overall quality of foreign capital utilisation.[65]

Following the release of the *Circular of the State Council on Several Measures Concerning the Expansion of Opening up and Active Use of Foreign Capital*[66] on 17 January 2017, Chinese authorities started implementing a series of policies and measures to expand foreign market access and improve the business environment for foreign companies (Table 3). More recently, on 16 August 2017, China's State Council issued its *Circular of the State Council on Several Measures to Boost the Growth of Foreign Investment*, which calls for the further opening up of sectors, enhanced fiscal and tax support policies, the development of platforms for Sino-foreign cooperation, better investment facilitation, and improvements to the business environment.[67]

The Work Report delivered at the 19th CPC National Congress further stated that China would not close its door to the world, but would instead accelerate its opening up process while giving equal emphasis to 'bringing in' and 'going global'. Particularly with respect to FDI, the Work Report affirmed that China would:[68]

- Implement the system of pre-establishment national treatment plus a negative list 'across the board'
- Further open the service sector
- Protect the legitimate rights and interests of foreign investors
- Further open China's western region
- Grant more power to free trade zones to conduct reform, while also exploring the opening of free trade ports
- Ensure that all businesses registered in China are treated equally.

[63] The European companies that participated in the 2017 edition of the *Business Confidence Survey* from the EU Chamber of Commerce in China reported revenue and profit growth in 2016. However, the survey suggests that these returns directly benefited from a large economic and fiscal stimulus package introduced in the first half of 2016. Without a substantive change in economic policy and management, the respondents felt this trend was unlikely to be sustained beyond two to three years. See: 'Business Confidence Survey 2017', EUCCC, May 2017, http://www.europeanchamber.com.cn/en/publications-business-confidence-survey

[64] '2018 China Business Climate Survey Report', AmCham China, January 2018, https://www.amchamchina.org/uploads/media/default/0001/08/19d4d046830d533f688e942159d9c4930d753e5d.pdf

[65] 'The 13th Five-Year Plan for Economic and Social Development of the People's Republic of China (2016-2020)', NDRC, 7 December 2016, http://en.ndrc.gov.cn/policyrelease/201612/P020161207645766966662.pdf

[66] 'Circular of the State Council on Several Measures Concerning the Expansion of Opening Up and Active Use of Foreign Capital', State Council of the People's Republic of China, 17 January 2017, http://www.gov.cn/zhengce/content/2017-01/17/content_5160624.htm

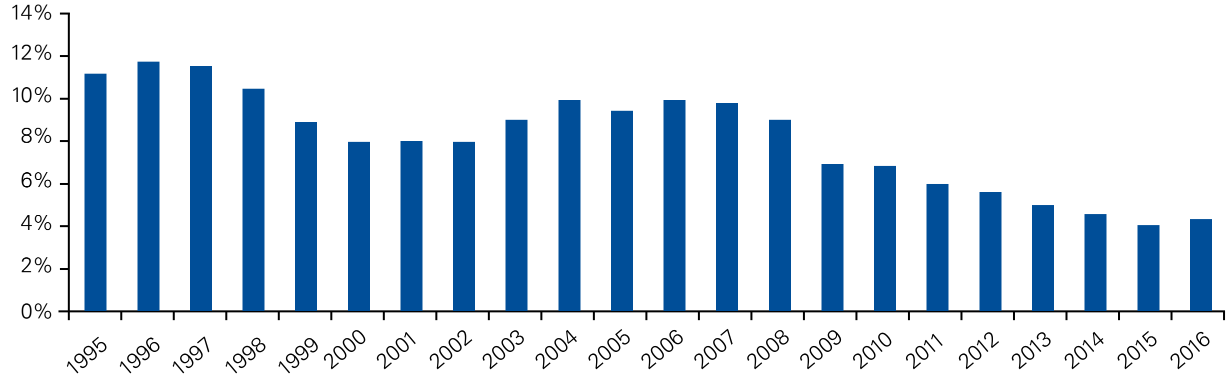
[67] 'Circular of the State Council on Several Measures to Boost the Growth of Foreign Investment', State Council of the People's Republic of China, 16 August 2017, http://www.gov.cn/zhengce/content/2017-08/16/content_5218057.htm

[68] 'Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era (Delivered at the 19th National Congress of the Communist Party of China, October 18, 2017, by Xi Jinping)', Xinhua News, 18 October 2017, http://www.xinhuanet.com/english/download/Xi_Jinping's_report_at_19th_CPC_National_Congress.pdf

This makes it clear that the Chinese Government is using and will use various measures to gradually achieve the new state of 'reform and opening up' called for in the 13th Five-Year Plan. Strong policy support in 2017, as well as policies that will be introduced to implement the `new vision of development' that President Xi Jinping advanced at the 19th CPC National Congress will accelerate China's opening up process and directly shape the institutional environment for future foreign investment in China.

These policies will lead to new investment opportunities for foreign companies; and it will become easier to make investments. KPMG China's flagship report, *The 13th Five Year Plan – China's Transformation and Integration with the World Economy*, provides an in-depth assessment of the investment opportunities for Chinese and foreign companies in the 2016-2020 period.[69]

Figure 37: Foreign investment as a share of total investment in fixed assets in China



Source: National Bureau of Statistics of China, WIND
Note: Foreign investment includes investments by 'foreign-funded' enterprises, and by companies registered in Hong Kong, Macau and Taiwan.

[69] 'The 13th Five-Year Plan – China's transformation and integration with the world economy: Opportunities for Chinese and foreign businesses', KPMG China, October 2016, https://home.kpmg.com/cn/13fyp-report2-en

Table 3: Various policies and measures to attract foreign investment introduced by the Chinese Government in 2017

Department	Policy measures	Date
State Council	*Circular of the State Council on Several Measures Concerning the Expansion of Opening Up and Active Use of Foreign Capital (Guo Fa [2017] No. 5)*	12 January 2017
Ministry of Housing and Urban-Rural Development (MOHURD)	*Measures for the Administration of Bidding for the Design of Construction Projects (Order of the MOHURD No. 33)*	24 January 2017
Standardization Administration of China (SAC)	*Circular on Issuing the Implementation Measures to Promote the Publicity of National Standards (Guo Biao Wei Xin Ban [2017] No. 14)*	3 February 2017
National Development and Reform Commission (NDRC); Ministry of Commerce (MOFCOM)	*Catalogue of Priority Industries for Foreign Investment in Central and Western China (2017 Revision) (Order of the NDRC and MOFCOM No. 33)*	17 February 2017
China Banking Regulatory Commission (CBRC)	*Circular on Carrying on Certain Businesses by Foreign Invested Banks (Yin Jian Ban Fa [2017] No. 12)*	10 March 2017
Ministry of Industry and Information Technology (MIIT)	*Minister Miao Wei clarified at the press conference for the 5th Session of the 12th National People's Congress that the 'Made in China 2025' plan offers equal treatment to domestic and foreign companies.*[70]	11 March 2017
The People's Bank of China (PBOC)	*Opinions on Implementing the Credit Policy in 2017 (Yin Ban Fa [2017] No. 48)*	11 March 2017
State Administration of Foreign Experts Affairs (SAFEA); Ministry of Human Resources and Social Security (MOHRSS); Ministry of Foreign Affairs (MFA); Ministry of Public Security (MPS)	*Circular on Fully Implementing the Licensing System for Foreigners to Work in China (Wai Zhuan Fa [2017] No. 40)*	28 March 2017
SAFEA	*Circular on the Implementation of Work Permit Services Guidelines for Foreigners in China (Temporary) (Wai Zhuan Fa [2017] No. 36)*	29 March 2017

[70] 'Regulator clarifies "Made in China 2025" plan after EU group criticism', Xinhua, 11 March 2017, http://www.xinhuanet.com/english/2017-03/11/c_136120363.htm

Key features
Ease restrictions on foreign investment in the services, manufacturing and extractive sector; support foreign participation in the implementation of China's strategy for innovation-driven growth, the transformation of the manufacturing sector, and infrastructure construction by the franchise model; create a fairer environment for competition; and further strengthen policy incentives aimed at attracting foreign capital such as supporting the land use for foreign investment projects.
Nullify the regulation requiring foreign design firms to receive approval from provincial-level authorities before participating in tenders for domestic architectural and engineering design projects.
Further enhance the openness and transparency around the process for setting and amending national standards; offer all mandatory national standards available to the public for free by 2018 and all national standards available to the public for free by 2020.
Expand the industry scope of encouraged foreign investment in Central, Western and Northeast China; facilitate the relocation of foreign invested businesses to Central, Western and Northeast China; promote the transformation and upgrading of traditional industries; support the development of high-tech industries and service sectors; and strengthen the development of infrastructure and supporting facilities.
Nullify administrative licensing by the CBRC for wholly foreign-funded banks, Sino-foreign joint venture banks and branches of foreign banks to undertake treasury bonds underwriting, custody services or financial advisory services; allow wholly foreign-funded banks, Sino-foreign joint venture banks and branches of foreign banks to carry out business collaboration with their parent banks (groups) in and outside of China; allow wholly foreign-funded banks and Sino-foreign joint venture banks to invest in Chinese banking institutions pursuant to the law.
'Made in China 2025' and relevant measures will treat domestic and foreign companies on a fair basis. Foreign companies will not be discriminated against, and the Chinese Government will not force foreign companies to transfer their technology to China.
Increase financial support for projects promoting public-private partnership models.
Implement a streamlined employment permit regime for foreigners in China, combining 'foreign employment permits' and 'foreign expert working permits' into a single 'work permit' administered with common standards and approval processes; simplify application documents and standardise application standards; optimise examination and approval workflow by introducing an 'Internet + Government Services' service system; classify foreign employees into three categories under a point-based system, and create a 'green lane' for high-end foreign talents.
Guide the implementation of *Circular on Fully Implementing the Licensing System for Foreigners to Work in China*, and increase policy transparency.

Table 3: Various policies and measures to attract foreign investment introduced by the Chinese Government in 2017 (Continued)

Department	Policy measures	Date
Ministry of Science and Technology (MOST)	*Circular on Issuing the 13th Five-Year Plan for the Development of Scientific and Technological Talents (Guo Ke Fa Zheng [2017] No. 86)*	13 April 2017
State Administration of Taxation (SAT)	*Announcement on Further Clarifying Matters on Tax Collection and Administration for the Program of Collecting Value-Added Tax in lieu of Business Tax (Announcement No. 11 [2017] of the State Administration of Taxation)*	20 April 2017
Ministry of Finance (MOF); SAT; MOST	*Notice of the Ministry of Finance, the State Administration of Taxation and the Ministry of Science and Technology on Raising the Proportion of Weighted Pre-tax Deduction of the Research and Development Expenses of Small- and Medium-Sized Scientific and Technological Enterprises (Cai Shui [2017] No.34)*	2 May 2017
MOST; MOF; SAT	*Circular of the Ministry of Science and Technology, the Ministry of Finance and the State Administration of Taxation on Issuing the Measures for Evaluating Small- and Medium-sized Tech Enterprises (Guo Ke Fa Zheng [2017] No.115)*	3 May 2017
SAT	*Notice of the State Administration of Taxation on Implementing Further Tax Cut Measures and Optimizing Tax Services (Letter [2017] No. 160 of SAT)*	12 May 2017
MIIT; MOF	*Circular of the General Office of the Ministry of Industry and Information Technology and the General Office of the Ministry of Finance on Issuing the Work Guidelines on Funds Used for Industry Transformation and Upgrading (Made in China 2025) in 2017 (Gong Xin Ting Lian Gui [2017] No. 53)*	24 May 2017
Ministry of Land and Resources (MLR)	*The MLR held meetings to advance policy implementation of the land use for industrial development*	25 May 2017
General Office of the State Council	*Circular on Issuing the Special Measures on the Administration of Entry by Foreign Investment in Pilot Free Trade Zones (Negative List) (2017 edition) (Guo Ban Fa [2017] No. 51)*	5 June 2017
MOST; MOF	*Interim Measures for the Administration of the National Key Research and Development Plan (Guo Ke Fa Zi [2017] No. 152)*	22 June 2017
NDRC; MOFCOM	*Catalogue of Industries for Guiding Foreign Investment (Revision 2017) (Order of the NDRC and MOFCOM No. 4)*	28 June 2017
State Council	*Circular of the State Council on Several Measures to Boost the Growth of Foreign Investment (Guo Fa [2017] No. 39)*	8 August 2017

Source: The information presented in this table summarises the key highlights of relevant policies, guidelines and regulations released by the Chinese Government.

Key features
Focus on introducing overseas high-end talents in key areas, such as the scientists leading international scientific R&D of major industrial technology application, as well as scientific and technical talents in major technological innovation; implement a more open policy on the introduction of foreign talents; create a 'green lane' for high-end foreign talents; and further improve immigration and residency management services for foreign talents in China.
Reduce the application time for VAT invoices; simplify tax payment processes.
Increase the proportion of weighted pre-tax deductions applicable to R&D expenditures at technological small- and medium-sized enterprises (SMEs), with equal treatment for foreign and domestic entities.
For the purpose of increasing precisely targeted support to technological SMEs, clarify evaluation methods for technological SMEs, which also apply to all types of resident enterprises registered within the territory of China (excluding Hong Kong, Macau and Taiwan).
Launch 10 taxation service measures to pave the way for the implementation of the new round of tax cut policies such as simplifying the VAT rate and expanding the scope of small- and micro-sized enterprises that are eligible for preferential tax treatment.
Provide financial support to priority areas that promote the transformation and upgrading of China's industrial sector, including standardisation and new model application of intelligent manufacturing, implementation of projects to build a more solid foundation for industry development, and 'green' manufacturing system integration. All types of resident enterprises registered within the territory of China can apply for special funding for projects promoting industrial transformation and upgrading (Made in China 2025).
Provide guidance and supervision over the policy implementation of local land use for industrial development; support land use for foreign invested industrial projects.
Further expand the market access for foreign investors within the pilot free trade zones by removing a total of 27 special administrative measures grouped under 10 categories, including manufacturing of rail transport equipment, pharmaceutical manufacturing, road transport, insurance, accountancy and auditing, and a number of other commercial services.
Promote foreign collaboration of national key research and development programmes by allowing the participation of independent legal entities registered in mainland China by overseas research institutions, universities and enterprises.
Further open the services, manufacturing and mining sectors to foreign investment; reduce the number of restricted industries by roughly one-third; introduce a nationwide negative list for foreign investment; increase the transparency of foreign investment policies.
Further reduce market access restrictions for foreign investors; fully implement the management systems of the 'pre-access national treatment' and the 'negative list'; formulate fiscal and taxation support policies to encourage foreign investors to continue expanding their investment in China; improve the investment environment of state-level development zones and introduce foreign-invested projects; improve the introduction system of foreign talents and actively introduce international high-end talents; improve the business environment by improving the legal systems of foreign investment and protection of intellectual property rights of foreign investors, as well as enhance the service quality of foreign investment.

1.4 Macroeconomic risks notwithstanding, China remains one of the world's most attractive investment destinations

As explained above, there is a comparatively high degree of investment risk during the starting phase of a 'new economic cycle'. During this period, China will experience many of the growing pains associated with an economic transformation. Certain contradictions and risks will remain unresolved, while uncertainties about the coming phase of development will continue to emerge.

While this will likely exacerbate the macroeconomic risks that foreign companies face when investing in China, provided these are properly managed, and as long as companies are able to identify the right time to capture opportunities, China will remain a popular investment destination for foreign multinationals to expand their global production and operations.

From an FDI perspective, China's macroeconomic risks primarily manifest in the following areas:

- **Policy risks – still present, but weakening:**

  Firstly, in terms of policy risks, there is no evidence of the reversal of open investment policies about which some foreign companies have expressed concern. However, reforms do remain insufficient in some areas, and in reality there are instances in which foreign companies are subject to unfair treatment. For instance, according to the European Union Chamber of Commerce in China's *Business Confidence Survey 2017*, 49% of surveyed companies reported that they no longer feel as welcome as they did when they first entered the Chinese market; only 4% of respondents believe that China had achieved significant progress in resolving market access issues; and 10% reported observing signs that the market was in fact closing.[71] As the Chinese Government continues to extend the introduction of policies to attract foreign investment, however, we believe policy risks to foreign investors will decrease in the coming years.

  Secondly, in terms of property rights, foreign companies continue to face challenges related to the protection of property and intellectual property. On 4 November 2016, the Chinese Government issued a policy document[72] instructing government agencies at all levels to ensure that all market players – regardless of ownership structures – are given equal access to factors of production; are able to compete openly, fairly and justly; receive unprejudiced protection from the legal system; and share a common standard of social responsibility. Government offices were also instructed to step up efforts to protect intellectual property rights (IPR), increase penalties for IPR violations, improve IPR enforcement mechanisms involving foreign parties, strengthen international cooperation on criminal enforcement, and better integrate the protection and utilisation of intellectual property (IP) to facilitate IP transfers and commercialisation.[73] Thanks to the implementation of these measures, we expect that the climate for property rights protection in China will be further improved. This will help avoid foreign companies having their property rights infringed and reduce the losses suffered as a result of such infringement cases.

- **Debt risks – present but subsiding:**

  The international community widely views China's high levels of debt as the most significant risk to the country's economic growth. Should a debt crisis break out in China, it would trigger systemic risks across the economy and threaten the security of foreign investments. However, as explained in Chapter 1, section 2.2, while the debt ratio in China's macroeconomic sectors has continued to increase, the rate of its growth is dropping sharply, particularly among non-financial firms and local governments, which typically have the greatest debt burdens. Going forward, the Chinese Government will continue to accelerate the deleveraging of SOEs, wind down 'zombie companies', and strictly control new issuances of local government debt.[74] As such, provided a certain degree of economic growth is maintained, China's debt risks should gradually subside. In the meantime, we expect that China will continue to open its markets and take steps to ensure a fairer business environment, further creating an attractive climate for foreign investment.

- **Financial risks – visible but manageable:**

  China's financial sector has experienced rapid growth in recent years, with its value added accounting for 8.35% of GDP[75] in 2016, a higher proportion than in the EU, US, Japan and some other major developed economies. There are risks related to vast amounts of capital cycling idly[76] between financial institutions, and the threat of that capital decoupling from the real economy. At the same time, regulation has lagged behind the industry's growth, leaving the Chinese economy vulnerable to serious financial risks. To a certain extent, this also increases the operating risks and financing costs of foreign investors.

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71 'Business Confidence Survey 2017', EUCCC, May 2017, http://www.europeanchamber.com.cn/en/publications-business-confidence-survey

72 'Opinions of the Central Committee of the Communist Party of China and the State Council on Improving the Property Right Protection System and Providing Law-based Protection to Property Rights', China's Central Government, 27 November 2016, http://www.gov.cn/zhengce/2016-11/27/content_5138533.htm

73 'Opinions of the Central Committee of the Communist Party of China and the State Council on Improving the Property Right Protection System and Providing Law-based Protection to Property Rights', China's Central Government, 27 November 2016, http://www.gov.cn/zhengce/2016-11/27/content_5138533.htm

74 For more information about these measures, see: 'The National Financial Work Conference held in Beijing', State Council of the People's Republic of China, 15 July 2017, http://www.gov.cn/xinwen/2017-07/15/content_5210774.htm. The term 'zombie companies' refers to companies that have partially or fully terminated production, are consistently unprofitable or insolvent, and rely primarily on government subsidies and bank refinancing to continue operations. See: 'China Daily: the exit of zombie companies must be decided by the market', Phoenix News, 11 January 2016, http://finance.ifeng.com/a/20160111/14159827_0.shtml

75 Data from WIND

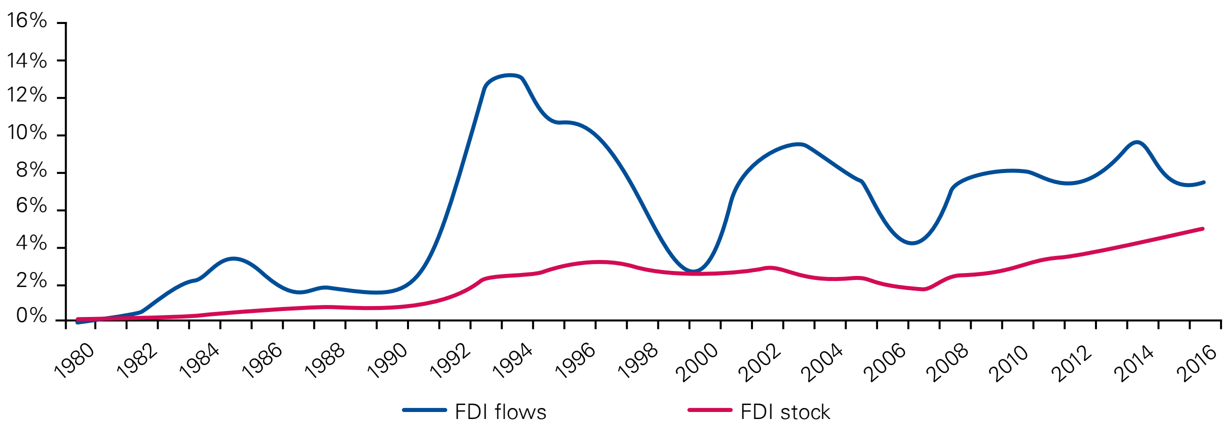
76 The 'idle cycling' of capital refers to money that circulates exclusively within the virtual economy (i.e. the finance industry) and does not in any way benefit the real economy (such as manufacturing).

Since 2017, the Chinese Government has been working to address serious issues related to financial risks using three key measures: ensuring that finance serves the real economy; controlling financial risks; and deepening financial reforms. These three measures will help reduce systemic risks in the Chinese economy and reduce the risks and costs associated with foreign investment. Additionally, after nearly two years of market calibration and policy adjustment, the depreciation pressure on the RMB has gradually eased since the second half of 2015. We expect that the RMB will continue to be stable in the foreseeable future,[77] helping to reduce currency risks to foreign investors.

Given ongoing weakness in global trade and investment flows, even while China's FDI growth has slowed, the country's share of the total global stock of FDI continued increasing in recent years, and reached 5.1% in 2016, behind the US and Hong Kong. Also, while China's FDI flows as a proportion of global flows have experienced some volatility, they have stayed at above 5% (Figure 38), trailing only the US and UK in 2016.[78]

Looking at the size of China's economy; the need for foreign capital, technology and expertise to enable China's economic transformation and upgrading; and the Chinese Government's intention to continue advancing the country's opening up process, as well as its efforts to address current macroeconomic risks, we believe that China continues to be one of the world's most attractive destinations for FDI, and will continue to enjoy this advantage in the near term.

Figure 38: China's FDI as a proportion of global FDI



Source: UNCTAD

[77] From a short-term perspective, China's economy appears stable, the government has a strong handle on the central parity rate pricing mechanisms of the RMB, and the USD is unlikely to spike again. These factors have significantly reduced the global market's interest in shorting the RMB. Even if the US and other major economies continue to raise interest rates, China's monetary policy still has room to raise interest rates accordingly, effectively preventing an increased spread and reducing deflationary pressure on the RMB. From a medium-term perspective, there is still strong potential for growth in the Chinese economy; together with a higher quality export structure, improved trade conditions, and the acceleration of the RMB internationalisation process, this will arguably create room for the future appreciation of the RMB.

[78] According to data from UNCTAD. See: `UNCTADstat', UNCTAD, http://unctadstat.unctad.org/EN/Index.html

2. China's evolving advantages in attracting investment

While China remains one of the world's most attractive host countries for foreign investment, foreign companies should have a clear understanding of how the country's advantages as an investment destination have evolved over time. Whereas China was once a destination for inexpensive factors of production, relatively lax environmental regulation and generous policy incentives, high-quality inputs, a vast end-user market and a well-regulated business environment are steadily taking shape as the new advantages for attracting foreign investment.

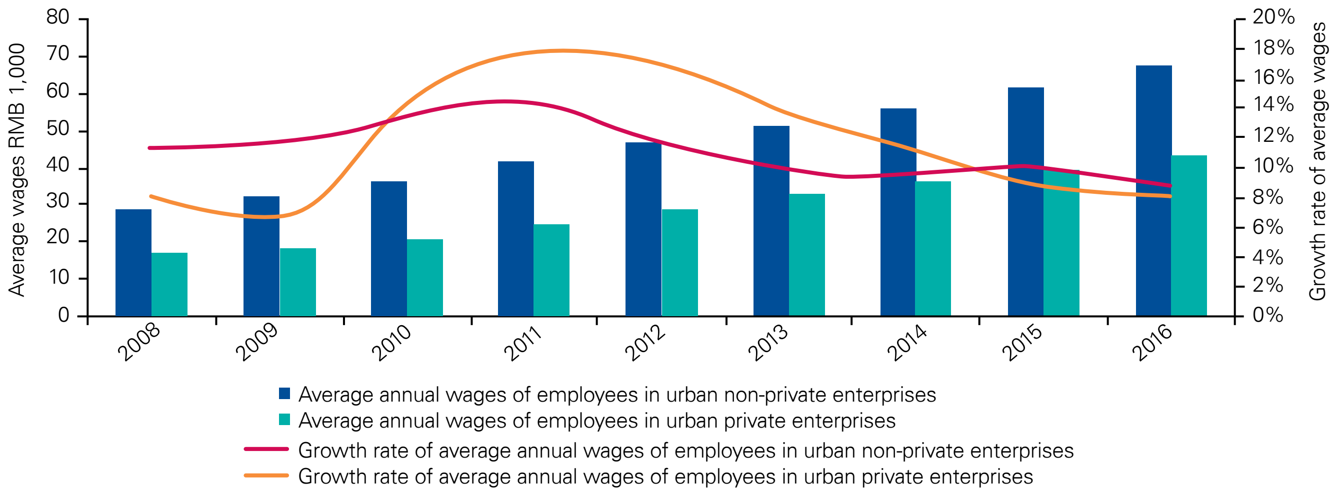
2.1 From 'cheap labour' to 'value-for-money', high-quality human capital

As China has developed economically, its working age population has decreased and the flow of rural workers to urban areas has slowed, leading to an overall rise in labour costs. Based on data from the National Bureau of Statistics of China, our calculations show that from 2008 to 2016, the average annual wages at state-owned and private urban employers registered an average growth rate of 11%, higher than the average growth rate that GDP and corporate profits registered during the same period (Figure 39). Foreign companies operating in China are certain to have felt the pressure of rising labour costs.

In parallel to this trend, however, the quality of China's human resources has improved significantly in recent years. China has had over 6.5 million graduates from undergraduate programmes every year since 2014, and over 500,000 from graduate programmes every year since 2013 (Figure 40), with both figures ranking the highest globally. The *Global Human Capital Report 2017* indicates that China, an emerging economy, ranks 34th worldwide in terms of human resources, above the average for East Asia, and second only to Russia amongst the BRICS economies.[79] China's performance in these global rankings stands out even more when the comparison is narrowed to younger population brackets. This shows that the pool of human capital resources which is available to promote innovation and foster new growth drivers is still increasing, and that there is an enormous need for the continued accumulation and improvement of human capital.

We can therefore see that from a demographic perspective, the advantages China offers to foreign investors are changing, from low-cost labour to high-quality human capital. Compared to some developed economies, China's high-quality human capital offers better value for money. According to unofficial estimates, China's average worker in the high-tech industry receives an average starting monthly salary of RMB 8,000-9,000 (USD 1,205-1,355),[80] compared with RMB 20,000 (USD 3,012) in Hong Kong and RMB 40,000-50,000 (USD 6,024-7,530) in the US.[81] Foreign companies should adapt to and take advantage of these changes in China's labour market by increasing investment in service, high-tech and other human capital-intensive sectors.

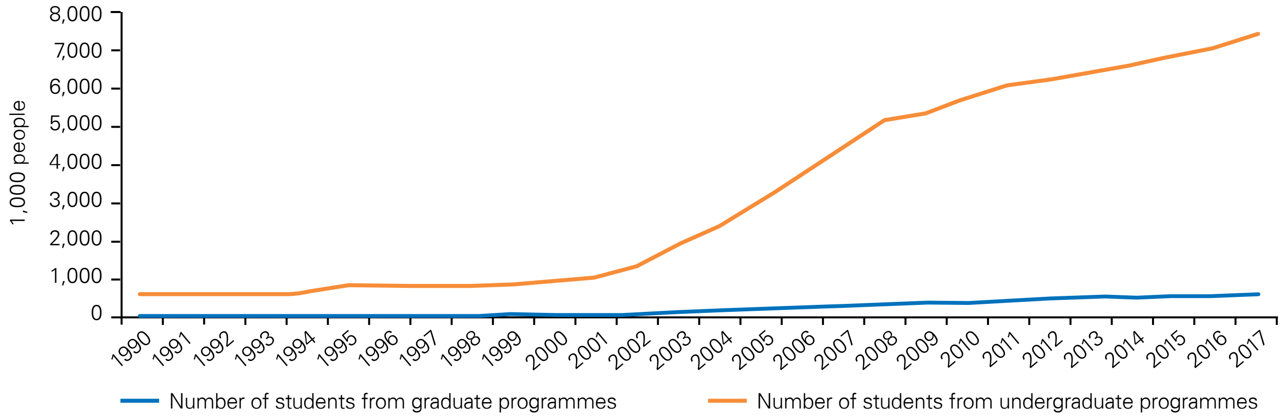
Figure 39: Average urban employee wages and wage growth



Source: National Bureau of Statistics of China; WIND

[79] 'The Global Human Capital Report 2017', World Economic Forum, 13 September 2017, http://www3.weforum.org/docs/WEF_Global_Human_Capital_Report_2017.pdf
[80] RMB to USD conversions calculated based on the average exchange rate in 2016
[81] 'Prominent economist Steven NS Cheung predicts that Shenzhen will overtake Silicon Valley within a decade', China Council for the Promotion of International Trade, 17 October 2016, http://www.ccpit.org/Contents/Channel_4113/2016/1017/704442/content_704442.htm

Figure 40: Number of students who have graduated from undergraduate and graduate programmes in China



Source: National Bureau of Statistics of China

2.2 *From soft environmental regulations to a comprehensive industrial ecosystem*

In order to attract foreign investment in the years following the start of the 'reform and opening up' era, China adopted relatively loose policies towards the environment, and towards resource and energy consumption. However, the Chinese Government is no longer willing to sacrifice China's ecological resources for the sake of achieving faster economic growth.

Since the 18th CPC National Congress, Chinese authorities have emphasised the importance of promoting the development of an 'ecological civilisation', and started implementing a series of strict resource and environmental protection standards and regulations, leading to a steady reduction of pollution and energy consumption levels (Figures 41-43).

Given the importance that President Xi Jinping attached to developing an 'ecological civilisation' and promoting green development in his report to the 19th CPC National Congress, the Chinese Government will continue its efforts to strengthen resource conservation and environmental protection measures. This will increase costs for foreign companies in areas relating to energy conservation and environmental protection, and may, to some extent, cause challenges for their China operations.

Although these policies are increasing the operating costs for foreign companies in China, the marked improvement in the quality of China's industrial infrastructure and concentration of industries and services should be conducive to reducing production and operating costs. We can see this in three main aspects:

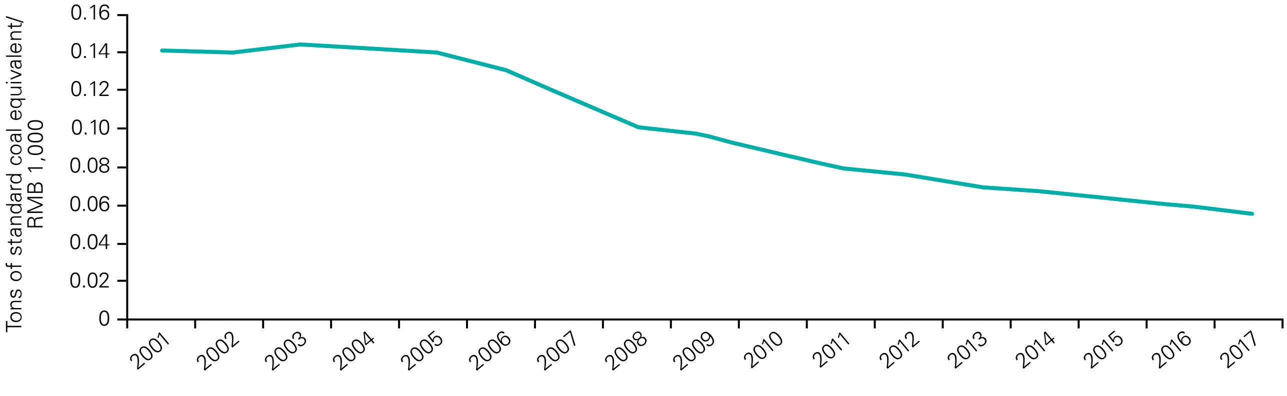
i. The scale and quality of China's transportation and internet infrastructure have improved markedly (Figures 44-45), with absolute coverage in some sectors reaching unparalleled global scale.

ii. Continuous upgrades are transforming the infrastructure of industrial parks where business clusters form. By the end of 2015, China led the world with 520 national-level industrial parks.[82]

iii. China boasts a broad diversification of industry. In 2010, China overtook the US to become the largest manufacturer globally, with the ability to produce 500 of the world's major industrial products, and ranking first globally in the production of 220 of those product categories.[83]

Together, these conditions mean that China offers one of the most comprehensive industrial ecosystems and related supporting infrastructure in the world. This is an important advantage in attracting more foreign investment. This is also why foreign companies investing in China should capitalise on these advantages to reduce their production and operating costs.

Figure 41: Energy consumption per unit of GDP in China

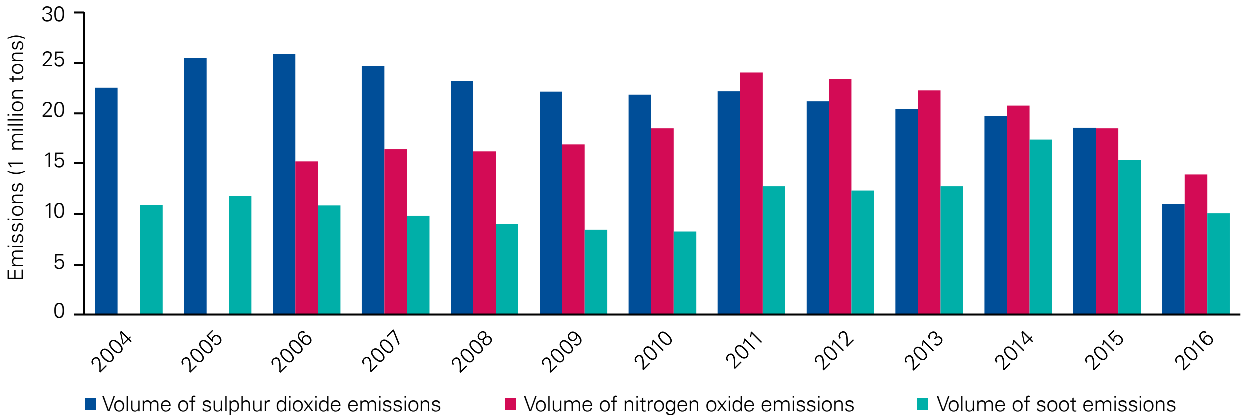


Source: National Bureau of Statistics of China

[82] For more analysis on the important role that industrial parks play in driving the economic development of China's regions see: '2016 Blue Paper on the Sustainable Development of Industrial Parks in China', Research Institute of Tongji University, Tongji University Press, December 2016.

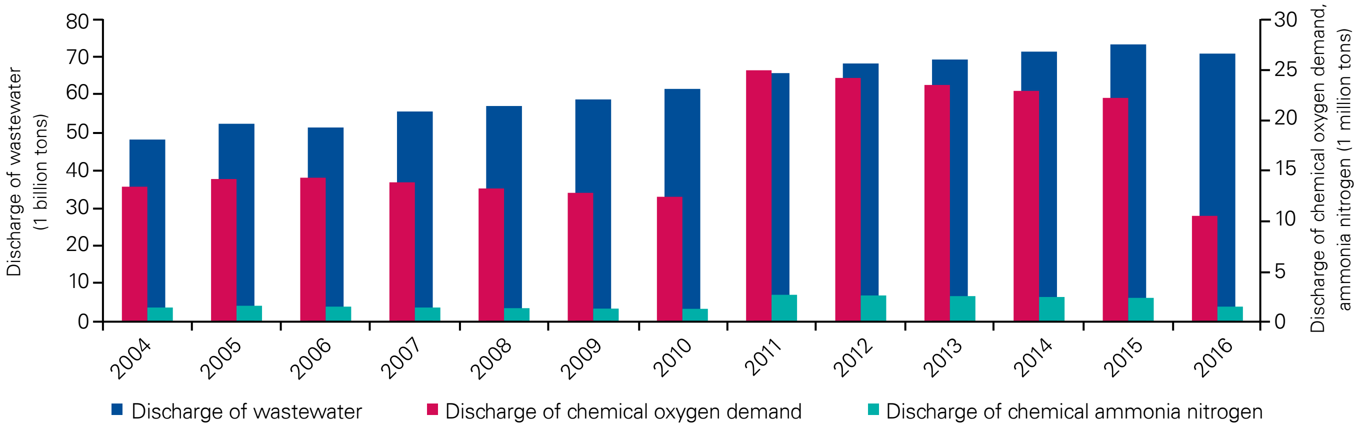
[83] RMB to USD conversions calculated based on the average exchange rate in 2016

Figure 42: Emissions of major pollutants in exhaust gas in China



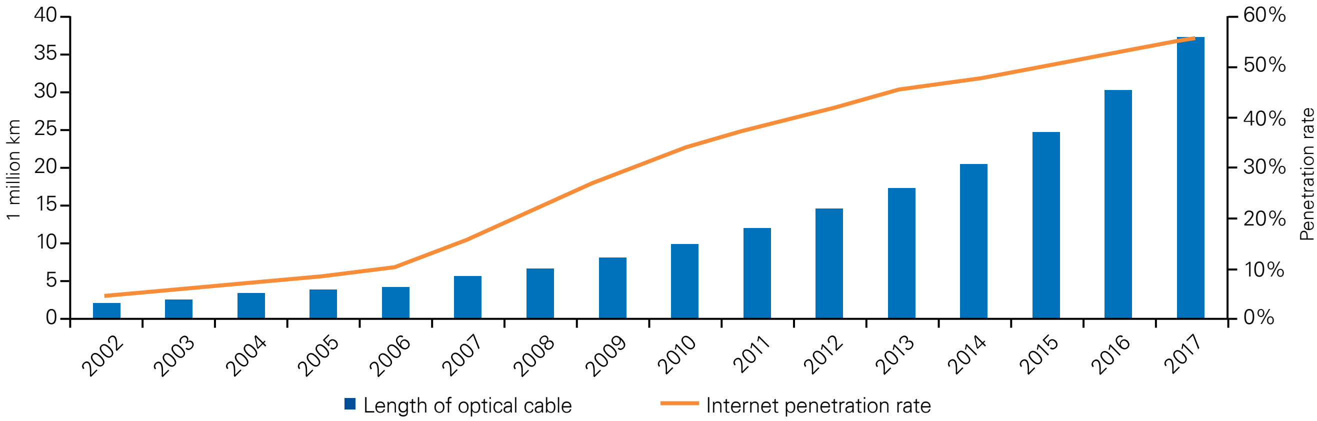
Source: National Bureau of Statistics of China; WIND

Figure 43: Emissions of major pollutants in wastewater in China



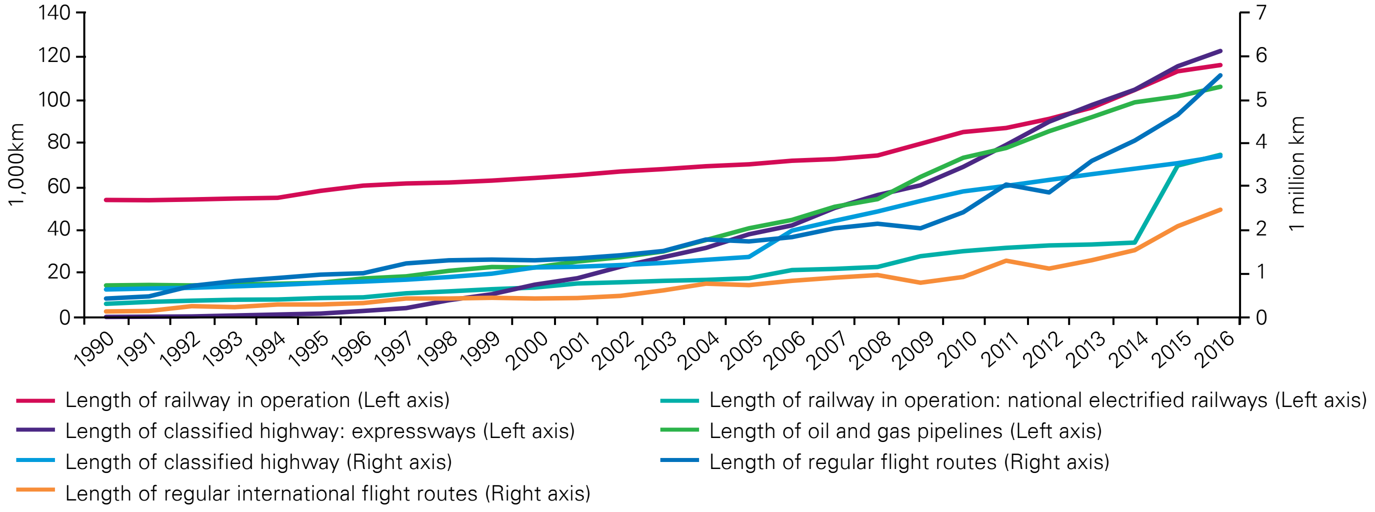
Source: National Bureau of Statistics of China; WIND

Figure 44: Internet infrastructure in China



Source: National Bureau of Statistics of China; WIND; Ministry of Industry and Information Technology of China
Note: Internet penetration rate refers to internet users as a share of the total population

Figure 45: Transportation infrastructure in China



Source: National Bureau of Statistics of China; WIND

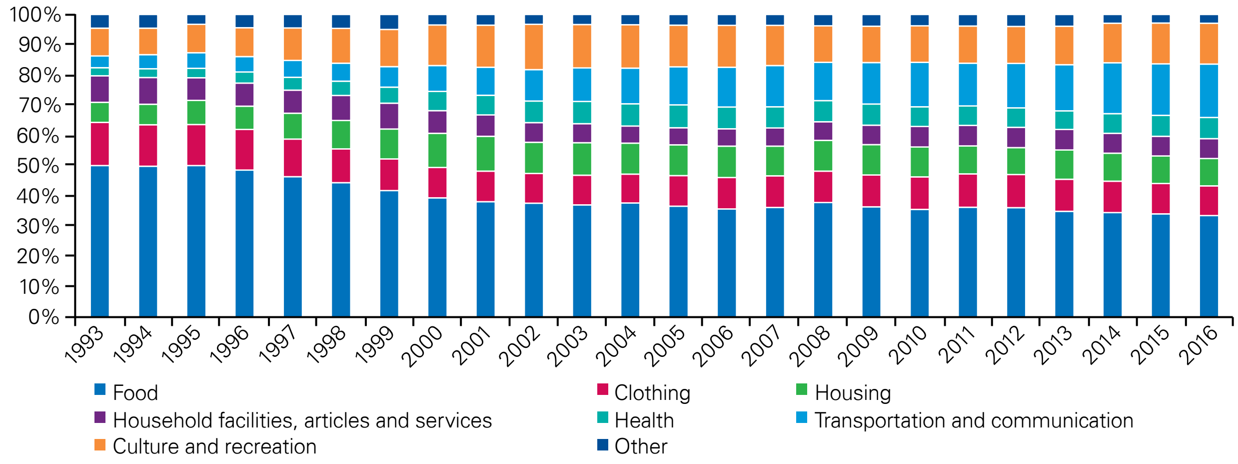
2.3 From a large low-end market to a large potential market for mid-range to high-end products

As a result of the market reforms which were implemented since the 1970s to accelerate China's opening up process, the country experienced a steady increase in household income levels, rapid urbanisation rates and an expansion of its middle class. This led to a drop in the Engel's coefficient of both Chinese urban and rural consumers,[84] indicating a shift in consumption trends from a focus on solely satisfying basic needs (i.e. spending on food, clothes and housing) to a focus on development (i.e. spending on education, transportation, communication and healthcare).

In recent years, as China's per capita GDP has approached the USD 10,000 mark, urban household incomes have steadily increased and consumer trends have further shifted to a focus on leisure (i.e. spending on entertainment, culture, household appliances and other consumer goods and services) (Figure 46). Furthermore, according to the 2015 edition of the *China Household Finance Survey* (CHFS),[85] China's middle class has grown to 204 million people, and controls a total wealth of around RMB 28.3 trillion (USD 4.5 trillion),[86] surpassing that of the US and Japan as the world's largest middle class.[87]

For this reason, China is emerging as the world's largest consumer market for mid-range to high-end products, which is another major advantage that the country offers for FDI. Foreign companies should be proactive in leveraging the opportunity presented by the growth of China's mid-range and high-end markets by investing in related sectors and product categories.

Figure 46: Urban household expenditure in China



Source: National Bureau of Statistics of China; WIND; KPMG analysis
Note: 2014-2016 data estimated based on trends

[84] Engel's coefficient refers to the proportion of personal consumption expenditures spent on food. As a nation becomes more prosperous and living standards improve, this proportion generally trends downwards.

[85] For the official website of *China Household Finance Survey* see: http://www.chfsdata.org/

[86] RMB to USD conversions calculated based on the average exchange rate in 2015

[87] 'China's middle class has grown to more than 200 million', Sohu News, 17 November 2015, http://business.sohu.com/20151117/n426657041.shtml

2.4 From generous policy incentives to an orderly business environment

After the start of the 'reform and opening up' era, Chinese authorities at the local level used incentives and preferential policies to attract foreign companies to invest and operate locally. These deliberate efforts to attract FDI were an important factor behind China's rapid growth over the past decades. However, the *Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform*, passed at the Third Plenary Session of the 18th CPC Central Committee, called for the establishment of a foreign investment management regime based on pre-entry national treatment and a negative list, and strictly forbids and punishes the promulgation of unauthorised preferential policies.[88] Since then, the Chinese Government has worked to scale back unauthorised preferential policies, as a result of which many foreign companies may now feel unwelcome.

In reality, the Chinese Government has been working to enact internal reforms and increase openness to cultivate a positive business environment and ensure a level playing field for both foreign and domestic companies:

- Firstly, China is accelerating market pricing reforms, allowing market forces to set prices for a wide range of important goods and services. Only 3% of goods and services are now priced by government fiat, allowing market forces to be the main determinant of prices.[89]
- Secondly, the government is accelerating the reform of sectors monopolised by the state. Substantive progress has been made in easing restrictions and encouraging mixed-ownership structures in SOEs operating in sectors such as power, oil and gas, rail, civil aviation, telecommunications, and defence.[90]
- Finally, Chinese authorities are also working to build an open, even and orderly market for competition. A series of anti-monopoly measures aimed at levelling the playing field, and a systematic review of fair competition to prevent administrative monopolies are forming the basis of a robust competition policy in China.[91]

Consequently, China's future efforts to attract foreign investment will not lie in preferential policies, but rather in offering a fair, open and just market environment. This will be conducive to foreign companies being accorded the same position in the market as domestic companies. These measures will also encourage companies to grow their business in China in ways which comply with laws and regulations.

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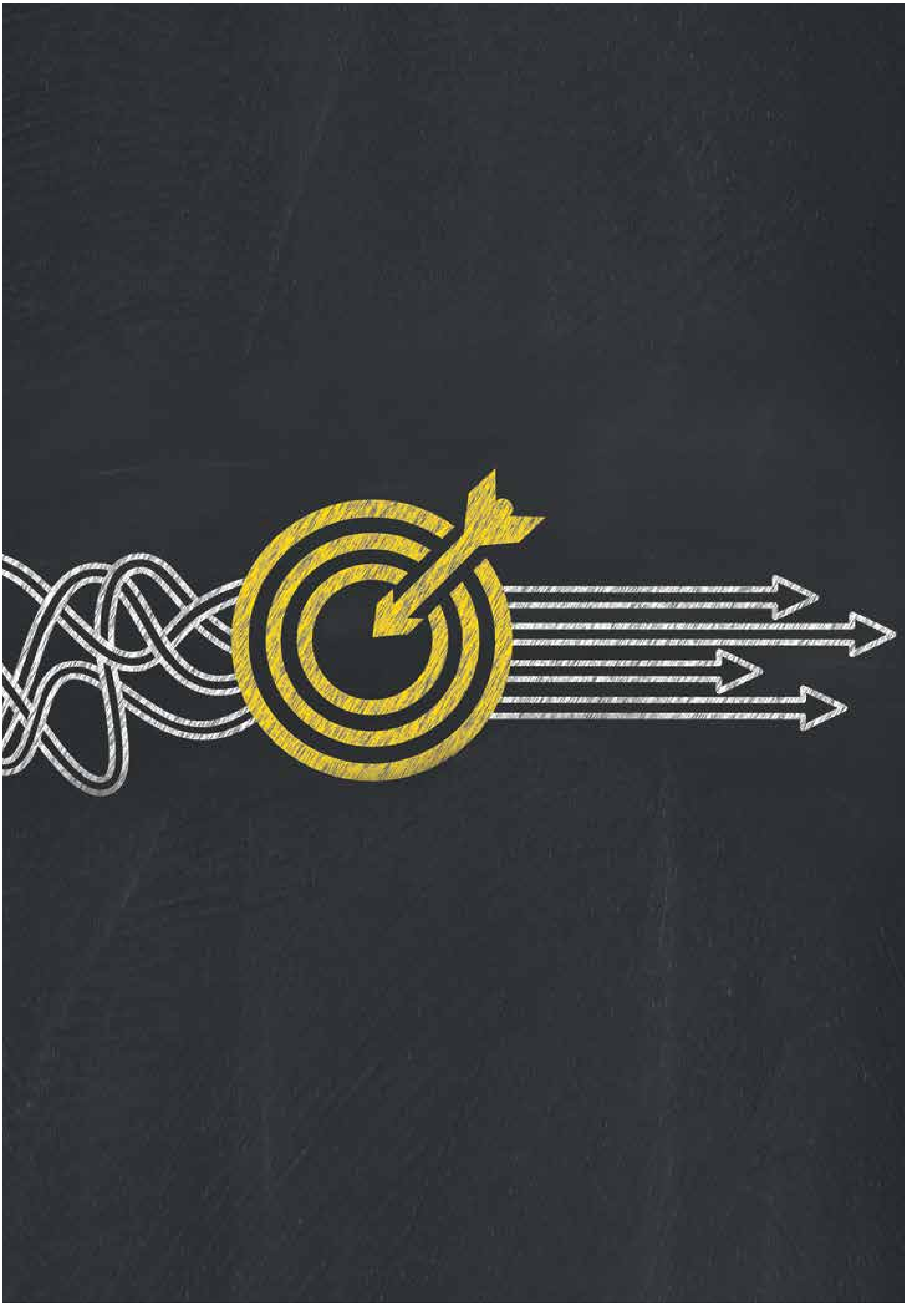
88 'Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening the Reform', The Supreme People's Court of the People's Republic of China, 15 November 2013, http://english.court.gov.cn/2015-10/08/content_22130532.htm

89 'NDRC: Market pricing mechanism takes shape, pricing by government fiat now less than 3%', China Economic Net, 26 July 2017, http://www.ce.cn/cysc/newmain/yc/jsxw/201707/26/t20170726_24486860.shtml

90 In September 2016, the NDRC unveiled the first batch of six central SOEs to pilot mixed-ownership reform, i.e. China Shipbuilding Industry Corporation, China Unicom, China Eastern Airlines, China Southern Power Grid, Harbin Electric Corporation, and China Nuclear Engineering & Construction Group Corporation Limited. The following year, in June-August, China Eastern Airlines' wholly-owned subsidiary, Eastern Air Logistics, and China Unicom announced reform plans involving the introduction of strategic investors and the implementation of market-oriented incentive schemes to push forward their mixed-ownership reform. This indicated that the benchmarking of mixed-ownership reform of central SOEs had been set, and consequently, that the reform could be replicated widely in other central SOEs. See: 'Central SOEs accelerate mixed-ownership reform', Sohu News, 24 August 2017, http://www.sohu.com/a/166949256_115124

91 In 2016, China's State Council issued a series of policy guidelines to implement a fair competition review system (FCRS), noting that "local protectionism, regional blockade, industry barriers, business monopoly, granting preferential policies in violation of the law, impairing the interests of market players, and other phenomena contrary to the efforts of building a unified national market and promoting fair competition still exist." The guidelines instruct policymakers to conduct a rigorous self-review process when developing policies related to the economic activities of market players – e.g. market access, industrial development, business and investment attraction, bidding, government procurement, operation regulation and qualification standards, to which end a series of directives, standards, exceptions as well as a basic approach are explained in detail. In October 2017 Chinese authorities released the implementing rules for the FCRS, not only clarifying the review mechanisms and basic approach for implementation, but also providing more policy guidance. See: 'Opinions of the State Council on Establishing a Fair Competition Review System During the Development of Market-oriented Systems', State Council of the People's Republic of China, 14 June 2016, http://www.gov.cn/zhengce/content/2016-06/14/content_5082066.htm; 'Implementing Rule of the Fair Competition Review System (Interim)', NDRC, 23 October 2017, http://jjs.ndrc.gov.cn/zcfg/201710/t20171026_864941.html



3. A structural evolution in China's FDI

As progress has been made with improving China's economic structure and fostering new drivers of growth, recent years have seen a corresponding evolution in the structure of FDI. Overall, foreign capital in China is trending towards high-end sectors and becoming more balanced than in the past. In 2018, as China enters a 'new economic cycle', the structural evolution of FDI will become even more pronounced.

3.1 From being driven by developed markets to being buoyed by emerging markets

Since China's 'reform and opening up' started, Hong Kong, Macau, Taiwan, the US, Japan, South Korea, the EU, and ASEAN member states have been the main sources of FDI. The US, EU, Japan and South Korea in particular were the main drivers of stable growth in foreign investment.

Since 2008, however, outbound investments from emerging markets into China have soared, especially as China's economic transformation has increased the country's alignment with the specialisation and trade regimes of other emerging economies. By investing in and building operations in China, companies from these emerging economies can meet the demand and tap the potential of the growing Chinese market, and deepen R&D collaboration and industrial cooperation with Chinese partners.

Emerging economies in Asia and Latin America have gradually become an important engine of FDI growth in China. In particular, Asia's share of total FDI into China has increased rapidly, driven by some ASEAN nations, while the rise in investments from countries such as Brazil and Paraguay since 2015 has contributed to reversing a post-crisis decline in the proportion of China's FDI coming from Latin America. Thanks to this, emerging economies have gradually become a new source of FDI growth in China (Figure 47).

3.2 From greenfield investment to cross-border M&A

As the Chinese economy continues to open, its capital markets mature, cross-border M&A governance is improved, and foreign investors in China shift their focus from the low end of the value chain to the high end, cross-border M&A is accounting for an increased proportion of total FDI. From 2010 to 2016, the value of cross-border M&A accounted for an average of 17.2% of total FDI flows, up nearly 10 percentage points from the average level during the period from 2003 to 2009 (Figure 48).

Based on international experience, cross-border M&A can often account for up to 80% or more of FDI in mature market economies. As China steadily enters a 'new economic cycle', therefore, with improved capital markets and foreign investment policies as well as accelerated economic transformation, the Chinese cross-border M&A market has tremendous room for growth, and its share in FDI is expected to continue to grow.

3.3 From regional imbalance to regional balance

The Chinese Government has invested considerable policy resources in the country's central and western regions to promote more balanced national development. Coupled with this, China's economic transformation process and industrial upgrading is improving the cost advantages of doing business in these regions, while also increasing the positive economic spillover effects from Eastern China into these areas. As a result, China's regional economic development is undergoing a profound shift, and the growth rates in the central and western provinces are significantly outpacing their peers in the east.

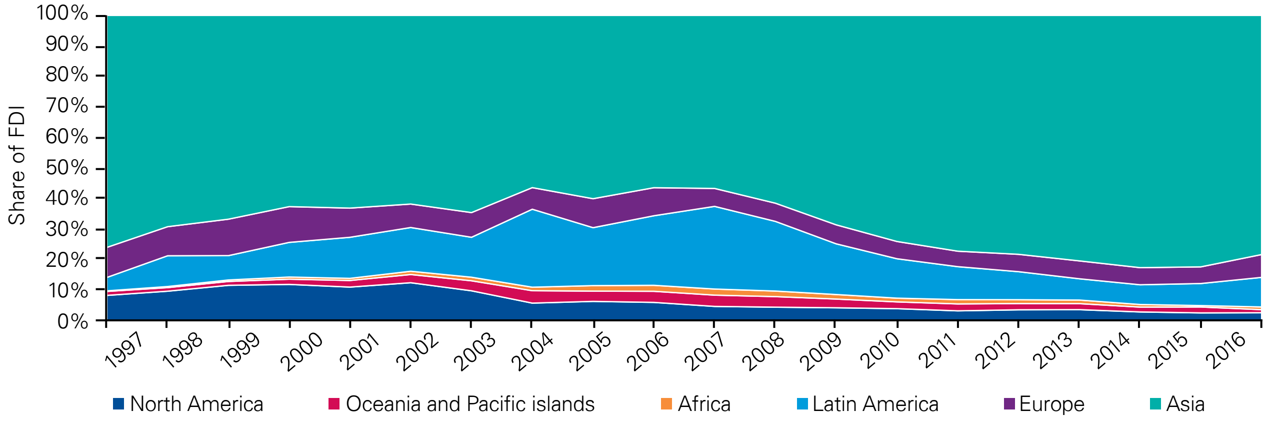
Foreign companies are taking note of this trend, with an increasing proportion of FDI flows going to central and western provinces. In 2016, 20.48% of China's total FDI was deployed in these provinces, a 6 percentage point increase from 1994. In comparison, while FDI into the eastern provinces accounted for 75.23% of the total in 2016, this represented an increase of 3.3 percentage points from 1994 (Figure 49).

Moving forward, as China's central and western provinces continue to grow at a faster rate than the national average, their 'second-mover advantage' will further boost their share of national FDI. Foreign investors should follow these growth trends and accelerate their investments in Central and Western China.

The continued economic slowdown in Northeast China has led to a decline in its share of national FDI since 2013, falling to a relatively low level of 4.28% in 2016. However, as the government accelerates its plans for the opening and revitalisation of Northeast China, this region will also become an important destination for foreign capital. This will lead to increasing investment opportunities for foreign companies in sectors such as modern equipment, modern services and large-scale agriculture.[92]

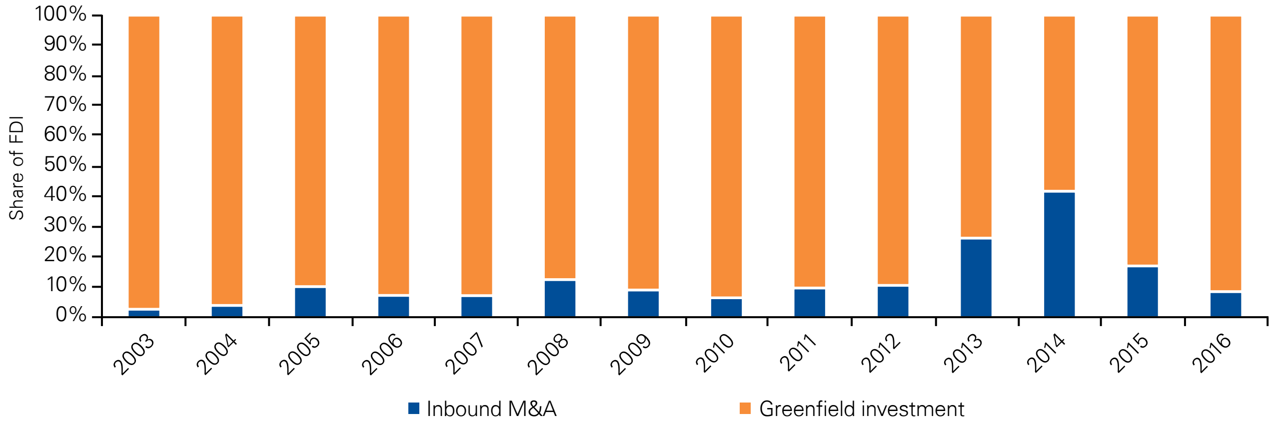
[92] 'Certain Opinions Regarding the Comprehensive Revival of Old Industrial Bases Including the Northeast', State Council of the People's Republic of China, 26 April 2016, http://www.gov.cn/zhengce/2016-04/26/content_5068242.htm

Figure 47: Sources of FDI into China by proportional flows



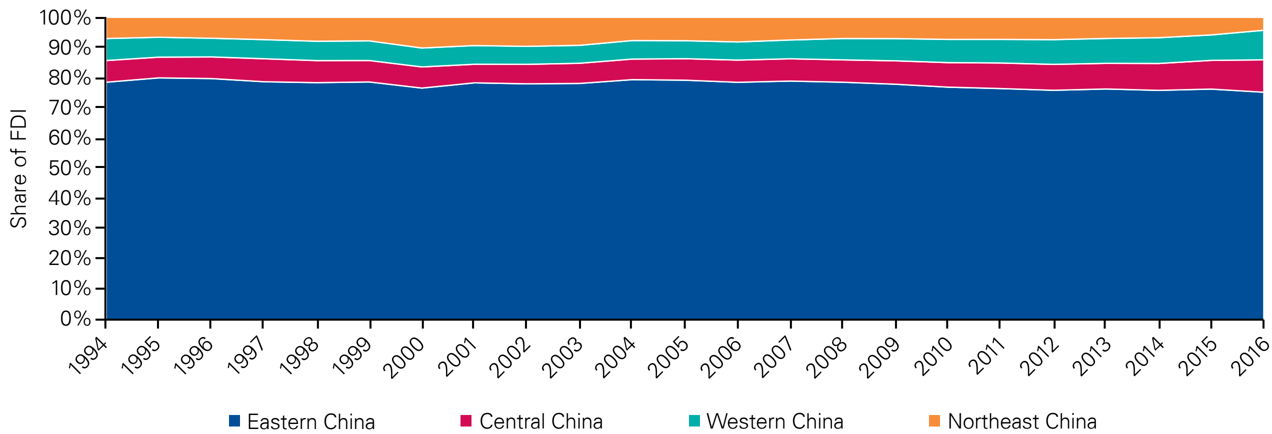
Source: UNCTAD; WIND

Figure 48: Greenfield investment vs inbound M&A as a share of FDI in China



Source: UNCTAD; WIND

Figure 49: Regional distribution of FDI in China



Source: Ministry of Commerce of China; WIND

3.4 From traditional manufacturing to services and high-end manufacturing

As described in Chapter 1, the Chinese Government is actively promoting the development of modern services and high-end manufacturing in order to upgrade China's industrial structure. The changes in industrial structure and supply chains have led to corresponding adjustments in FDI flows.

Firstly, FDI growth in services is dramatically outpacing manufacturing. From 2008-2016, FDI into China's manufacturing sector registered a negative average annual growth rate of -1.07%, while FDI growth in the services sector averaged 12.79% (Table 4). FDI in the tertiary industry (i.e. services) as a share of total FDI rose from 41.1% in 2008 to 66.6% in 2016, while that for the secondary industry fell from 57.6% to 31.9% over the same period (Figure 50).

In terms of specific industries, the most visible growth in FDI was seen in the high-tech manufacturing of computers and office equipment; pharmaceuticals; electronics and telecommunications equipment; as well as in the high-tech services sector, including the provision of information services, R&D, design and the commercialisation of new technologies.[93]

This signals that China's FDI flows are shifting from traditional manufacturing to high-tech manufacturing and modern services. Foreign companies should adjust the sectoral make-up of their investments in China to take advantage of new trends in the development of industries and the new demand created by these changes, expanding investment in high value added industries to increase the potential to derive even greater commercial advantage from the China market.

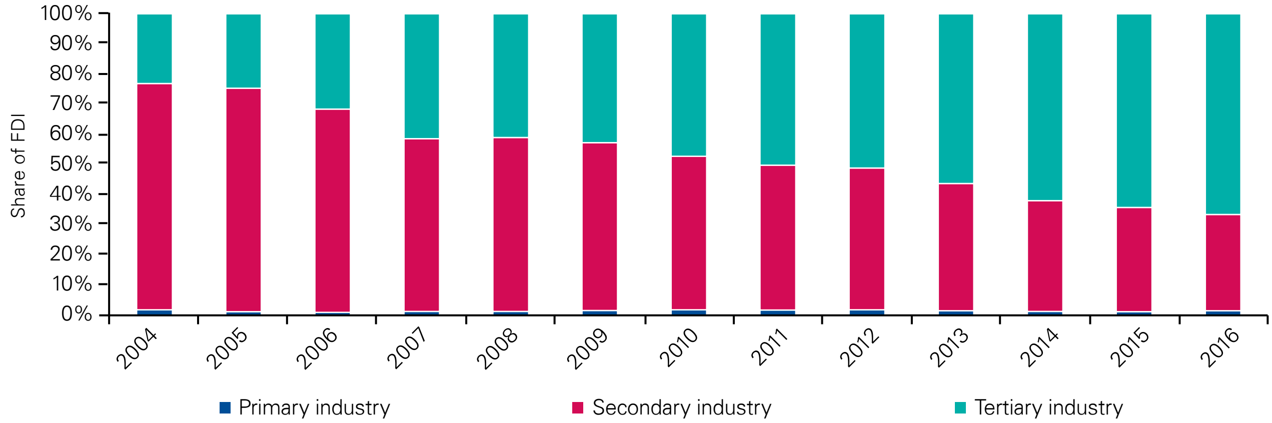
Table 4: FDI growth rates in major industry sectors in China (%)

Year	Manufacturing	All services	Real estate	Education	Finance
2008	22.10	24.7	8.78	12.17	122.5
2009	-6.26	-1.61	-9.65	-62.95	-20.33
2010	6.03	29.51	42.80	-39.36	146.3
2011	5.06	18.72	12.07	-51.71	69.98
2012	-6.21	-0.31	-10.25	770.1	10.98
2013	-6.78	17.04	19.37	-46.99	9.96
2014	-12.3	13.16	20.24	15.09	79.46
2015	-0.99	10.18	-16.26	38.01	257.9
2016	-10.24	3.72	-32.21	224.14	-31.26
2008-2016 Average	**-1.07**	**12.79**	**3.88**	**95.39**	**71.72**

Source: National Bureau of Statistics of China; WIND

93 'MOFCOM Department of Foreign Investment Administration Comments on China's Assimilation of Foreign Investment in January-July', Ministry of Commerce, 17 August 2017, http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201708/20170802628440.shtml

Figure 50: Primary, secondary and tertiary industries as a share of FDI in China[94]



Source: National Bureau of Statistics of China; WIND

	Transportation, warehousing and postal services	Scientific research, technical services and geological survey	Wholesale and retail	Culture, sports and entertainment	Information transmission, computer services and software	Leasing and commercial services
	42.09	64.24	65.62	-42.77	86.82	25.88
	-11.36	11.16	21.58	23.00	-19.02	20.15
	-11.22	17.52	22.37	37.33	10.67	17.31
	42.21	24.96	27.73	45.50	8.55	17.56
	8.87	25.95	12.31	-15.44	24.41	-2.04
	21.41	-11.15	21.66	52.98	-14.22	26.19
	5.65	18.34	-17.79	0.32	-4.36	20.50
	-6.05	39.17	27.05	-4.13	39.22	-19.5
	21.57	43.96	32.00	-66.16	120.07	60.52
	12.57	**26.02**	**23.61**	**3.40**	**28.02**	**18.51**

[94] According to the industry structure that the National Bureau of Statistics of China uses, the primary industry consists of agriculture (including farming, forestry, animal husbandry and fishery); the secondary industry includes mining and quarrying, manufacturing, production and supply of electricity, water and gas, as well as construction; and the tertiary industry includes the rest of the sectors, which provide various kinds of services for production and consumption. See '3. National Accounts', National Bureau of Statistics of China, http://www.stats.gov.cn/english/ClassificationsMethods/Definitions/200204/t20020419_72392.html

4. New mindsets needed for investing in a 'new economic cycle'

As seen in the previous sections, the role that China sees for FDI, the country's advantages as an investment destination, and the composition of its inbound investment flows are all undergoing change and adjustment. These changes will continue and intensify after the country enters a 'new economic cycle'. When investing in China, foreign companies will need to adopt four 'new mindsets' to adapt to the new features of the Chinese economy.

4.1 A mindset of careful planning and disciplined execution: Investing in China under the 'new normal'

After 'reform and opening up' started, China's economic development took off: input costs were low, the scope of industrial opportunity was broad, business operations enjoyed wide room for manoeuvre and foreign companies could make profits with relative ease.

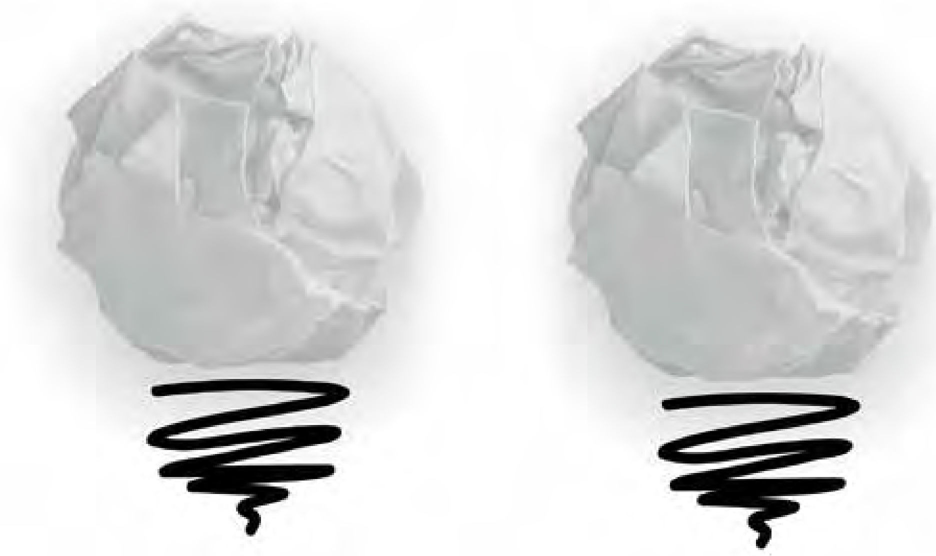
However, China has entered a 'new normal' phase of its economic development, which is bringing a clearer economic landscape, a higher level of economic development, more mature economic institutions, and increasing competition from Chinese companies. This means it is no longer easy for foreign companies to be successful when investing in China.

To adapt to the economic trends and changing industry structures in the 'new normal', and achieve sustainable growth and success requires careful planning and disciplined execution: focus on your core business, identify comparative advantages, and build core competitive strengths.

4.2 A mindset of risk management and control: Investing in China given new macroeconomic risks

Years of fast-paced growth have left a legacy of increasingly apparent risks for China's economic and social development. Risks associated with the country's economic slowdown, high levels of macroeconomic debt and systemic contagions in the financial system could affect the country's economy at large, and potentially lead to major losses for foreign companies investing and operating in China.

China is also going through a critical phase of its reform and proactively adjusting its institutions and policies. If foreign companies are unable to adapt swiftly to these institutional and policy changes, they may well face significant operating risks. Additionally, social tensions and other problems are surfacing, bringing some degree of risk to foreign companies investing and operating in China. Consequently, as China transitions to a 'new economic cycle', foreign companies should establish a mindset of risk management and control to avoid these economic and social risks having negative impacts on their production and operations.



4.3 A deeply strategic mindset: Investing in the context of China's new advantages

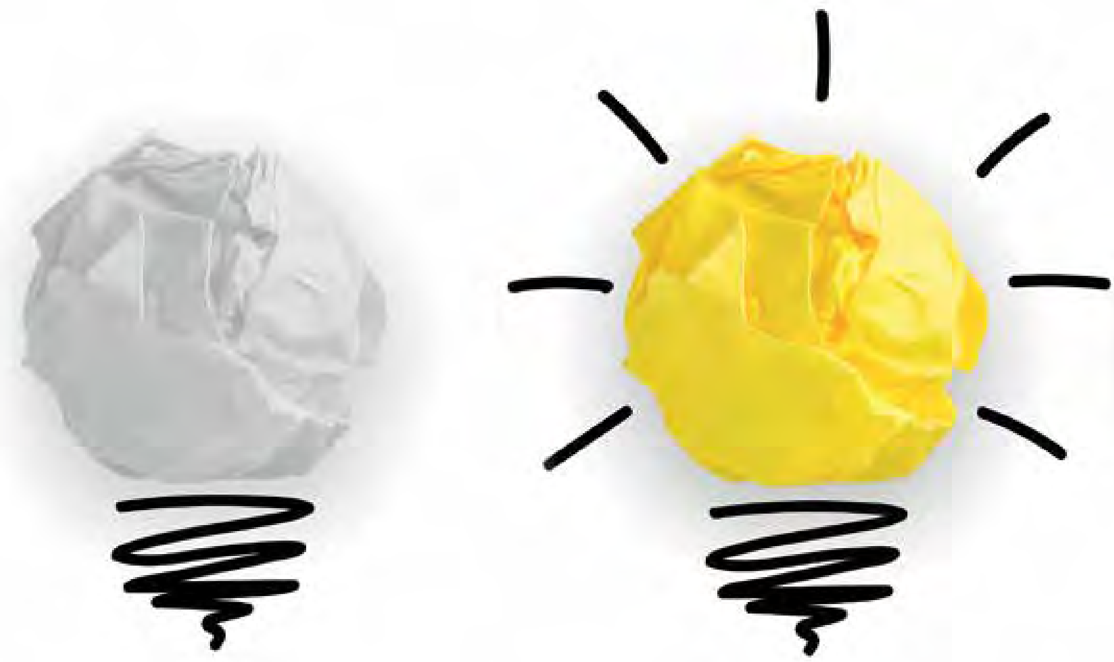
For a long time, foreign investment in China sought to take advantage of low costs, and was primarily concentrated in manufacturing and processing sectors at the low end of the industrial value chain. As the advantages that China offers foreign investors have begun to evolve and the country's overall economic structure continues to improve, however, foreign companies are actively evolving their approaches both in terms of which sectors to invest in and how to undertake those investments. Foreign companies are starting to work closely with the Chinese Government and local enterprises to meet domestic market demands, and shift their production model from 'Made in China' and 'Made for China' to 'Made with China'. This shift is not only expressed through a quantitative increase in investment in China, but also through growth in quality investment in critical high value-added sectors such as R&D and branding, and a clear trend towards greater localisation. It is also reflected in foreign companies' placement of their regional – and sometimes even global – headquarters in China, making their investments in China the core of their global investment and operations strategy.

Given this context, successful foreign companies in China are gradually adopting a more 'strategic mindset', making more high-end and localised investments, and placing China at the heart of their global investment strategy. Only by continuing this trend and maintaining a competitive advantage in China can foreign companies take full advantage of the new opportunities offered by this phase of China's development by making new investments in China and in other markets around the world.

4.4 A mindset of proactive compliance: Investing in China in the new business environment

The Third Plenary Session of the 18th CPC Central Committee adopted the *Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening the Reform*, which called on China to establish an open market system with orderly competition and fair, open, transparent market rules. The decision calls for the implementation of a modern market system in which companies can operate autonomously and compete fairly, consumers can freely select and consume products and services, and commodities and inputs can be freely and equitably exchanged.[95] This will help both foreign and Chinese companies (including state-owned and privately owned) engage in fair market competition, secure equal access to the factors of production, and enjoy equal protection under the law.

Going forward, with stricter management of China's market and more frequent enforcement of anti-monopoly policies, foreign companies that previously invested and operated in China by taking advantage of regulatory gaps will be forced to adjust their investment strategy or risk severe challenges to their operations. As the system and rules governing China's market are improved, foreign investors in China should establish a mindset of proactive compliance in order to meet the demands of China's new phase of market development and achieve legal, compliant and reasonable business and profit growth.



[95] 'Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening the Reform', The Supreme People's Court of the People's Republic of China, 15 November 2013, http://english.court.gov.cn/2015-10/08/content_22130532.htm

Chapter 3

A new phase for ODI: From quantitative growth to quality-oriented development

While outbound investment from most major economies began flagging after the financial crisis in 2008, Chinese ODI bucked the trend with robust growth that saw China become the second largest exporter of capital in the world in 2016.[96]

However, in 2017, Chinese ODI experienced a significant drop-off in growth. Non-financial ODI – i.e. excluding investments into securities, insurance and banking – fell during the first 10 months of 2017, a trend which was finally reversed in November, when it grew 34.9% YOY to USD 21.2 billion, and December when it increased by 49% YOY to USD 12.5 billion. Overall, however, China's non-financial ODI in 2017 still dropped 29.4% YOY to USD 120.08 billion.[97]

This reversal in China's ODI growth trajectory does not reflect a decrease in the need or appetite of Chinese companies to invest overseas. Rather, it was mainly policy-driven, and in line with the steps taken to increase regulatory oversight of overseas investments to ensure that they: are not speculative in nature, are undertaken after fully considering the risks, and are consistent with the company's strategy and the country's socio-economic development goals.

The decrease in ODI has mainly been in sectors such as real estate, hotels, and film and entertainment, all of which have been identified as restricted by the Chinese Government. Conversely, authorities are encouraging ODI in sectors such as services, advanced manufacturing and high-tech, as well as overseas investments that foster international agricultural cooperation and support the implementation of the 'Belt and Road' Initiative.

As the multilateral cooperative framework for the BRI becomes better established, we expect the potential for outbound investment by Chinese companies to only increase further, and the introduction of more supporting measures to make it easier for Chinese companies to undertake overseas investments. Additionally, the gradual onset of the 'new economic cycle' and the continued expansion of the Chinese economy will fuel increased demand for Chinese companies to acquire and 'bring back' international resources to support the country's economic transformation. The 'new paradigm of globalisation' is also likely to accelerate the flow of international capital across borders. For these reasons, we believe that in the long term, China's outbound investment will maintain a medium-to-high growth rate, and will gradually evolve from quantitative growth to quality-oriented development. As such, efforts by Chinese companies to invest overseas will not stop; on the contrary, they will become a leading force in the next wave of globalisation.

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[96] 'World Investment Report 2017', UNCTAD, June 2017, http://unctad.org/en/PublicationsLibrary/wir2017_en.pdf

[97] 'MOFCOM Department of Outward Investment and Economic Cooperation Comments on China's Outward Investment Cooperation in 2017', Ministry of Commerce, 18 January 2018, http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201801/20180102706193.shtml

The 'Belt and Road' Initiative

1. China has become a major provider of global investment

The theory of international production – also known as the 'eclectic paradigm (OLI) of international production' – and the history of global ODI suggest that as a country moves towards the top of the middle-income bracket, it would experience high capital outflows and an acceleration of outbound investment.[98] China's GDP per capita reached USD 8,808 in 2017, and is on track to surpass USD 12,235 by 2022,[99] edging it just over the minimum threshold to be considered high-income.[100] Based on both academic theory as well as empirical evidence, we believe China's overseas investment will continue a quality-oriented, healthy development, and China will remain a major global provider of cross-border capital.

1.1 China is one of the world's largest outbound investors

China's ODI reached USD 183.1 billion in 2016, making it a net exporter of capital for the first time, and surpassing Japan to become the second largest outbound investor in the world behind the US (Figure 51).[101] That same year, China's outbound investment flows also increased their global share to 12.6% (Figure 53).

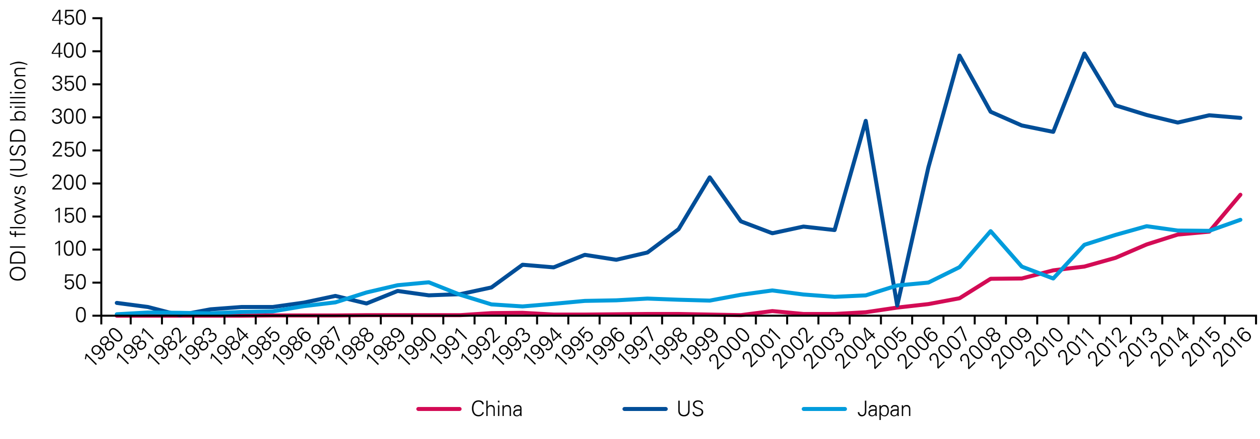
1.2 China has the world's sixth largest stock of foreign investment

In 2016, China accounted for 4.9% of the global ODI stock, i.e. the sixth largest share in the world (Figures 52 and 53). Based on current growth rates, we expect China to surpass the ODI stock levels of Hong Kong, the UK, Japan and Germany by 2020, becoming the world's second largest holder of ODI stock behind the US. As more Chinese companies 'go out', this will drive demand for their Chinese suppliers to also expand their overseas networks so they can support the overseas investments and operations of these companies.

1.3 China will become the main engine of global cross-border investment in the future

While global cross-border investment activity has been weak since the 2008 financial crisis, China's contribution to the growth of such investment remained relatively high for several years. In 2016, China's contribution to growth of global ODI flows reached 39.2%, second only to the UK (Figure 54). Given its rising per capita GDP, increasingly competitive companies and more mature modes of operating overseas, we expect China to emerge as an important engine of overseas investment over the coming years, with Chinese companies becoming a key driver of global cross-border investment and business activity worldwide.

Figure 51: ODI flows – China vs other nations



Source: UNCTAD

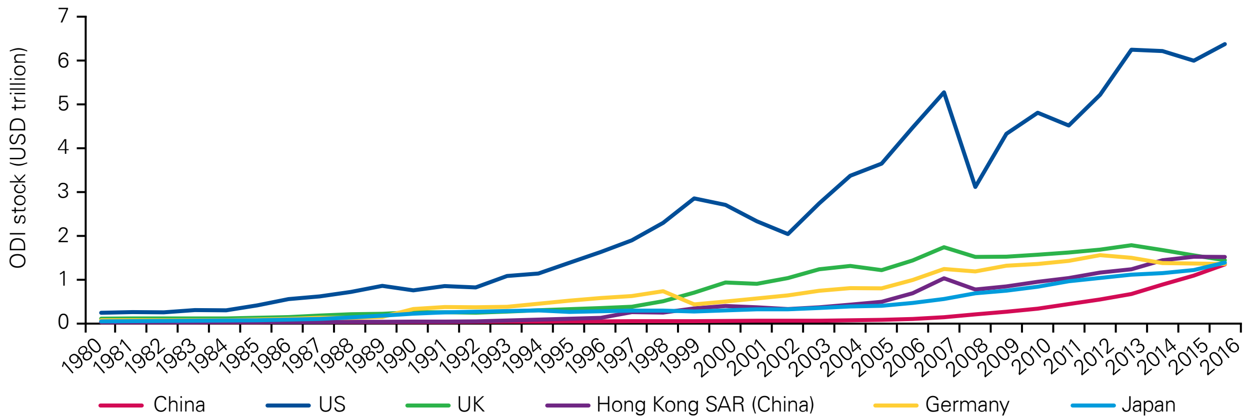
[98] On the relationship between a nation's capital flows and its economic development, this theory explains that during the early stage of a country's development, its capital flows are small and primarily consist of inbound foreign capital; as its economy grows, inbound and outbound investment grow closer together in scale, and when its economy has reached a relatively mature stage, capital outflows increase to the point of surpassing capital inflows. See: 'International Production and the Multinational Enterprise', John Harry Dunning, published by Allen & Unwin, London, 1981.

[99] China's GDP per capita for 2017 was calculated based on the latest available data by the National Bureau of Statistics of China. The country's GDP is estimated to have reached RMB 82.7 trillion in 2017, while China's population reached 1.39 billion as at the end of 2017. IMF's forecasts are used for China's GDP per capita estimate for 2022. RMB to USD conversions are calculated based on the average exchange rate in 2017. See: 'Statistical Communique of the People's Republic of China on the 2017 National Economic and Social Development', National Bureau of Statistics of China, 28 February 2018, http://www.stats.gov.cn/english/PressRelease/201802/t20180228_1585666.html; 'World Economic Outlook Database (October 2017)', IMF, accessed on 6 February 2018, http://www.imf.org/external/datamapper/datasets/WEO

[100] According to the World Bank's most recent classifications published in 2017, countries with a per capita national income of over USD 12,235 are classified as high-income countries – per capita GDP and per capita national income are nearly equivalent. See: 'New country classifications by income level: 2017-2018', The World Bank, 1 July 2017, https://blogs.worldbank.org/opendata/new-country-classifications-income-level-2017-2018

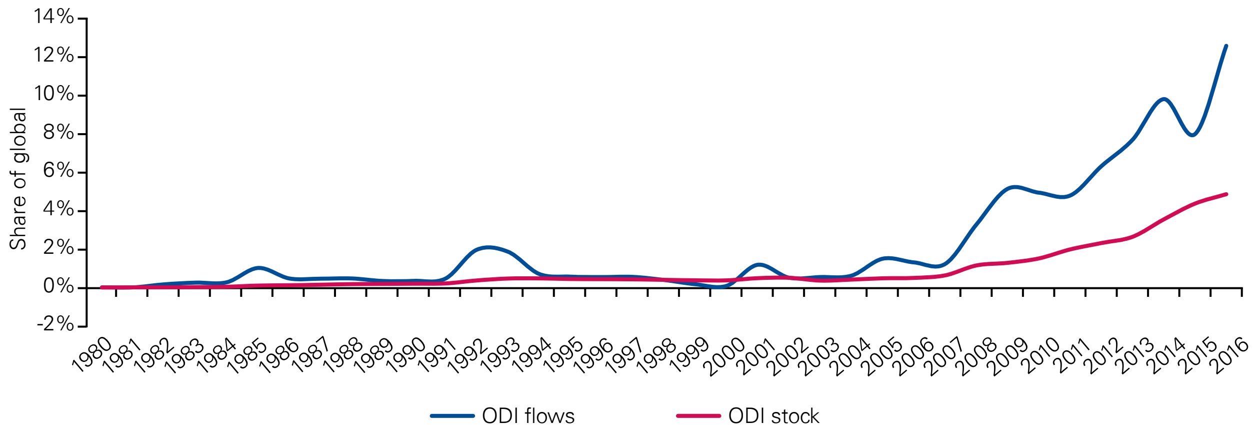
[101] According to data from UNCTAD. See: 'UNCTADstat', UNCTAD, http://unctadstat.unctad.org/EN/Index.html

Figure 52: ODI stock – China vs other nations and regions



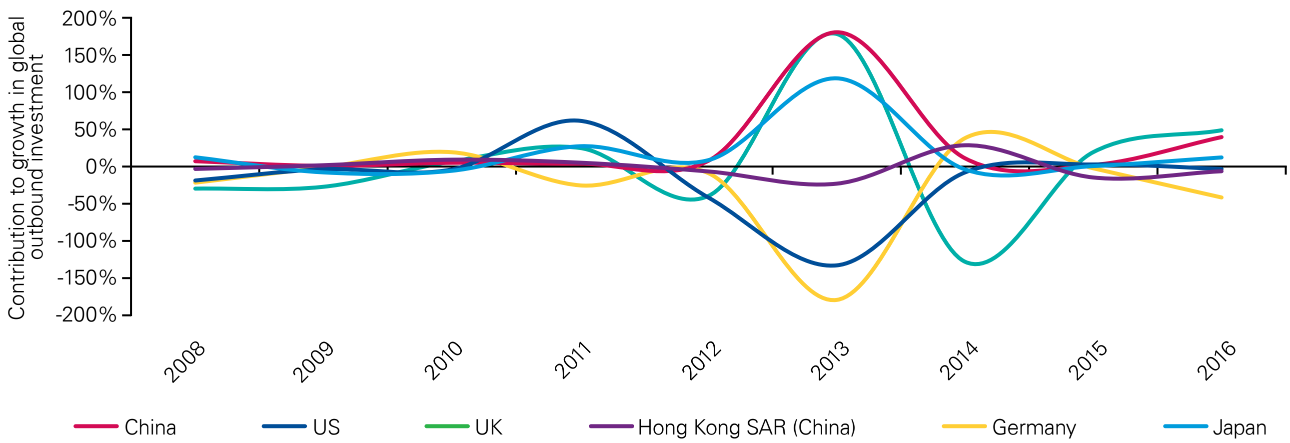
Source: UNCTAD; WIND

Figure 53: Chinese ODI flows and stock as a share of global total



Source: UNCTAD; WIND

Figure 54: Major economies' relative contributions to growth in global ODI flows



Source: UNCTAD

2. Chinese companies are beginning to reassess their outbound investments

Chinese companies have gradually adapted to international markets after many years operating overseas. As China's own domestic industry is undergoing sustained upgrade and transformation, Chinese companies are beginning to make more rational assessments of their overseas investments, with the acquisition of high-quality international assets emerging as an important objective. These shifts in investment rationale and operational focus have had a major impact on the main sectors and regions where Chinese companies have been making overseas investments.

2.1 A shift from the acquisition of energy and natural resources, to key inputs needed for business operations

For a considerable time, the extractive industries were the largest net recipients of China's ODI, as Chinese companies investing overseas were primarily focused on the acquisition of energy and mineral resources to support domestic production. However, this trend has shifted over recent years, with more Chinese companies 'going out' to acquire technology, expertise and high-quality brands and products. This has enabled them to capture opportunities derived from China's economic transformation and meet the evolving demands of Chinese consumers.

Official statistics show that China's investment in overseas extractives started declining in 2013, while growing rapidly in sectors such as manufacturing, scientific research, technical services, geological prospecting, information transmission, computer services and software, and leasing and business services (Figure 55). This trend reflects a continuing shift up the global value chain for Chinese capital.[102]

This 'shift to quality' in China's ODI has been supported by government policies, especially following the 18th CPC National Congress in 2012, where technological and business model innovation was elevated to the core of China's development strategy. Since then, the Chinese Government has promulgated a series of policies to guide companies' outbound investments in order to: access high-quality operational resources that can facilitate the country's industrial upgrading, improve its indigenous innovation capabilities and contribute towards increasing the quality of consumption. These policies include:

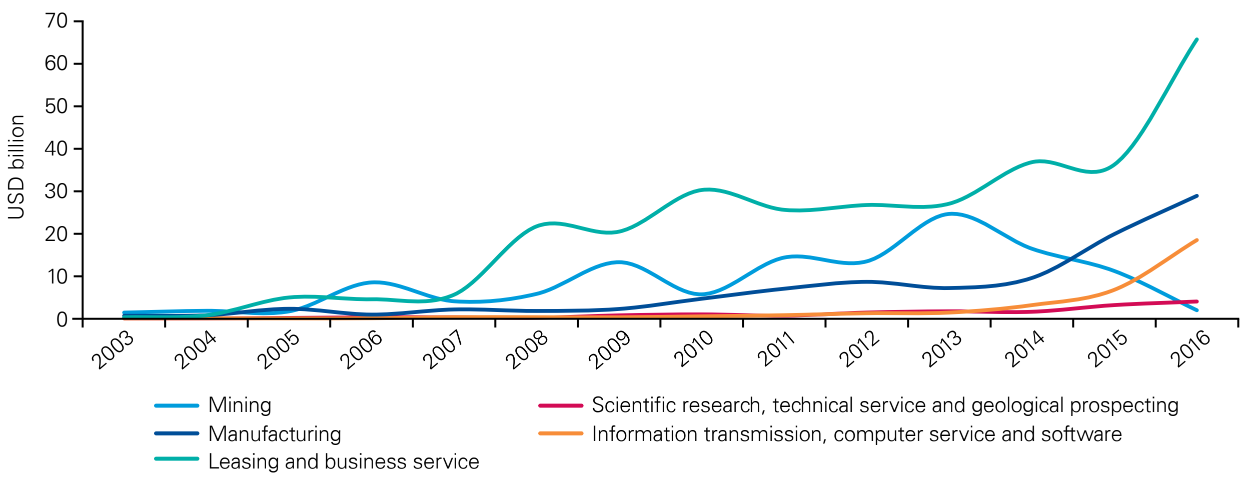
- **'Made in China 2025' plan:**

  Published in May 2015, the plan calls for China to support the development of multinational corporations that raise China's core competitiveness in advanced manufacturing through global sourcing, business process reengineering, supply chain consolidation and capital market operations.[103]

- **'Internet Plus' plan:**

  Published in July 2015, this plan calls to leverage major national strategies such as the BRI to support and encourage China's competitive internet firms to take the lead in global expansion along with companies in the manufacturing, finance and telecommunications sectors. Chinese companies can work together and leverage their strengths through a combination of overseas M&A, joint operations and the establishment of overseas offices to expand business in global markets; deepen international production capacity cooperation; establish cross-border industrial value chains; and enhance global competitiveness.[104]

Figure 55: Net Chinese ODI by sector



Source: National Bureau of Statistics of China; Ministry of Commerce of China; WIND

[102] Further analysis on how China's ODI has evolved and moved up the value chain can be found in MOFCOM's annual reports on this topic. The latest edition can be found here: 'Report on Development of China's Outward Investment and Economic Cooperation 2016', Ministry of Commerce, December 2016, http://fec.mofcom.gov.cn/article/tzhzcj/tzhz/upload/zgdwtzhzfzbg2016.pdf

[103] 'Made in China 2025', Chinese Central Government, 19 May 2015, http://www.gov.cn/zhengce/content/2015-05/19/content_9784.htm

[104] 'Guiding Opinions of the State Council on Actively Promoting the "Internet Plus" Action', Chinese Central Government, 4 July 2015, http://www.gov.cn/zhengce/content/2015-07/04/content_10002.htm

- ***Guiding Opinions of the State Council on Boosting the Leading Role of New Consumption to Speed up the Cultivation of New Supplies and Engines:***

  Published in November 2015, this policy document calls for companies to adopt more proactive strategies for internationalisation; better utilise global markets and inputs to upgrade domestic industry; and more efficiently use global products and services to meet the increasingly diverse and sophisticated demands of the domestic consumer market.[105]

- **National Innovation-driven Development Strategy Outline:**

  Published in May 2016, this strategy calls for the Chinese Government to support Chinese companies' efforts to develop a global network of innovation, encourage them to establish overseas R&D centres, and improve their capacity to effectively manage the commercial exploitation of intellectual property rights in overseas markets.[106]

Under the guidance of these policies, more Chinese companies have begun 'going out' to invest in innovative companies, as well as to establish R&D centres and business incubators in foreign markets in order to connect with international resources engaged in innovation. By doing this, Chinese companies are able to achieve critical breakthroughs in technology and move further up the industrial value chain. Furthermore, by investing in high-end industries overseas to acquire quality assets, Chinese companies can provide high-quality, international-grade goods and services to consumers back home. It is clear, therefore, that Chinese companies' rationale for 'going out' is increasingly focused on the acquisition of high-quality assets and resources, and that their outbound expansion strategies going forward will be oriented towards elevating each link on the industrial value chain to a truly international standard.

2.2 A shift from asset allocation and value preservation to strategic deployment and operations

As a result of the impact that the 2008 financial crisis had on China's real economy, some Chinese companies and individuals started 'going out' in search of assets that could deliver higher returns than available in the domestic market. This resulted in an acceleration of Chinese overseas investments into assets within the real estate, and cultural, sports and entertainment sectors (Figure 56). Given that many of the tangible and intangible assets in these sectors are fairly liquid, some of these overseas investments may have been undertaken for asset allocation and value preservation reasons, resulting in a degree of capital flight. In response to this trend, the Chinese Government started tightening its regulatory oversight on outbound direct investments into overseas real estate, and cultural, sports and entertainment assets since the end of 2016.[107]

Official statistics on China's ODI flows in 2017 indicate that the rationale for overseas investments has begun shifting away from asset allocation and value preservation, and towards more globally strategic purposes. During the first seven months of 2017, China's overseas investment in real estate dropped 81.2% YOY and accounted for 2% of total non-financial ODI, while overseas investments in cultural, sports and entertainment assets fell 79.1% YOY, accounting for 1% of the total non-financial ODI.[108] According to the Ministry of Commerce, there were no new Chinese overseas investment projects in these sectors from August to December last year.[109] Chinese outbound investments in 2017 were mainly directed to leasing and commercial services (29.1% of total non-financial ODI); manufacturing (15.9%); the wholesale and retail industries (20.8%); and information transmission, software and IT services (8.6%).

In August 2017, the Chinese Government enacted further restrictions on overseas investment in assets such as real estate, hotels, cinemas, entertainment businesses and sports clubs. Instead, Chinese companies were encouraged to strengthen their investment cooperation with foreign high-tech and advanced manufacturing firms, and judiciously expand investment in service sectors related to trade, culture and logistics (Table 5).

As Chinese companies internationalise and their overseas operations mature, their overseas investments are increasingly based on strategic objectives. Guided by reasonable government policies and driven by increasingly sophisticated development needs, Chinese companies' investments abroad are becoming more rational and strategic than ever before.

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[105] 'Guiding Opinions of the State Council on Boosting the Leading Role of New Consumption to Speed up the Cultivation of New Supplies and Engines', Chinese Central Government, 23 November 2015, http://www.gov.cn/zhengce/content/2015-11/23/content_10340.htm

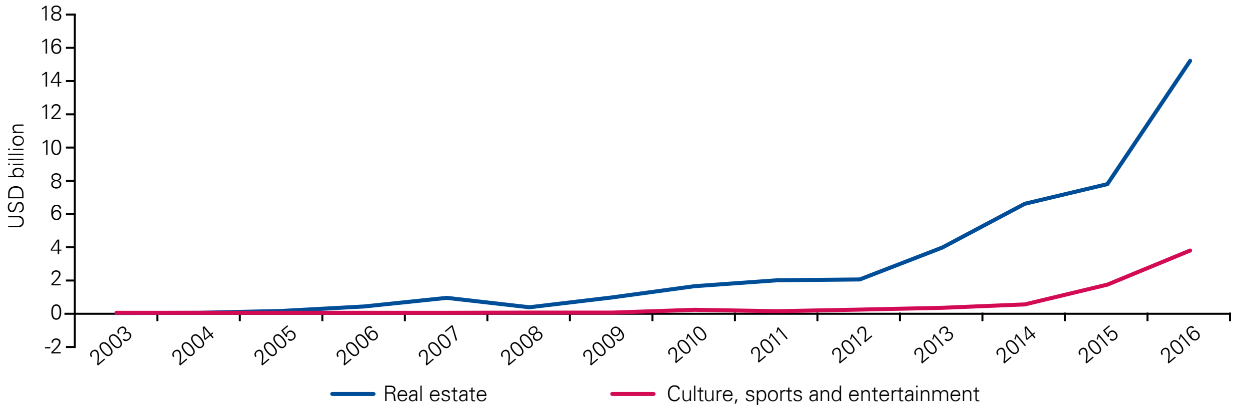
[106] 'National Innovation-driven Development Strategy Outline', Chinese Central Government, 19 May 2016, http://www.gov.cn/xinwen/2016-05/19/content_5074812.htm

[107] 'Leading Officials of the NDRC, MOFCOM, the PBOC and SAFE answer questions on heightened scrutiny and supervision over outbound investments in current trends', Sina News, 6 December 2016, http://news.sina.com.cn/o/2016-12-06/doc-ifxyicnf1763934.shtml

[108] 'MOFCOM Department of Outward Investment and Economic Cooperation Comments on China's Outward Investment and Cooperation in January-July 2017', MOFCOM, 17 August 2017, http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201708/20170802628458.shtml

[109] 'MOFCOM Department of Outward Investment and Economic Cooperation Comments on China's Outward Investment Cooperation in 2017', MOFCOM, 18 January 2018, http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201801/20180102706193.shtml; 'MOFCOM Department of Outward Investment and Economic Cooperation Comments on China's Outward Investment Cooperation in January-October 2017', MOFCOM, 17 November 2017, http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201711/20171102674847.shtml; 'MOFCOM Department of Outward Investment and Economic Cooperation Comments on China's Outward Investment Cooperation in January-August 2017', MOFCOM, 18 October 2017, http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201710/20171002657749.shtml

Figure 56: Net Chinese ODI in real estate and cultural, sports and entertainment industries



Source: National Bureau of Statistics of China; Ministry of Commerce of China; WIND

Table 5: The Chinese Government's recent initiatives to regulate ODI activity

Category	Industries and other guidance/requirements/limitations
Encouraged overseas investment	Overseas infrastructure investment that facilitates the 'Belt and Road' construction and the interconnectivity of peripheral infrastructure; overseas investment to promote the exporting of advanced capacity, high-quality equipment and technical standards; cooperation with foreign high-tech and advanced manufacturing enterprises, and the establishment of R&D centres abroad; steady participation in the exploration and development of overseas oil and gas, minerals, and other energy resources; mutually beneficial and win-win investment cooperation on agriculture, forestry, animal husbandry, fishery and other areas; overseas investment in business and trade, culture, logistics and other areas of services in an orderly manner; and the establishment of offshore branches and service networks by qualified financial institutions
Restricted overseas investment	Overseas investment in sensitive countries and regions where China has not established diplomatic ties, are at war, or are restricted by bilateral or multilateral treaties or agreements of which China is a signatory; overseas investment in real estate, hotels, cinemas, entertainment and sports clubs; overseas establishment of equity investment funds or investment platforms without actual, specific industrial projects; overseas investment using outdated production equipment that does not meet the technical requirements of the investment recipient country; overseas investment that does not meet the environmental protection, energy consumption and safety standards of the recipient country
Prohibited overseas investment	Overseas investment involving the export of core technology or product from the military industry without the approval of the government; overseas investment involving the use of technology, techniques or products that are banned from export by the government; overseas investment in industries such as gambling and pornography; overseas investment that is banned by international treaties concluded with or signed by China; other overseas investments that endanger or may endanger national interests and national security

Source: 'Opinions on Further Guiding and Regulating the Direction of Overseas Investments', State Council of the People's Republic of China, 18 August 2017, http://www.gov.cn/zhengce/content/2017-08/18/content_5218665.htm

2.3 A shift from traditional partners to nations along the 'Belt and Road'

As implementation of the BRI progresses, China's overseas investments in the 'Belt and Road' region have grown much faster than the country's investments in the US, EU and other traditional investment destinations. In 2016, Chinese companies conducted USD 14.5 billion of overseas investments in 'Belt and Road' countries; USD 126 billion in new overseas project contracts were signed with partners in the region – accounting for 51.6% of the total – while completed projects achieved a turnover of USD 75.9 billion – i.e. representing 47.7% of total completed turnover of China's contracted projects overseas.[110]

In 2017, China's non-financial ODI in 59 'Belt and Road' countries reached USD 14.36 billion, accounting for 12% of total ODI, an increase of 3.5 percentage points over the same period in 2016. The value of newly signed overseas project contracts in 61 'Belt and Road' countries reached USD 144.32 billion, accounting for 54.4% of the global total, up 14.5% YOY. Completed turnover of contracted projects in the region reached USD 85.53 billion, accounting for 50.7% of the global total, up 12.6% YOY.[111]

Implementing the BRI is an important endeavour by the Chinese Government to promote a 'new paradigm of globalisation' and, as such, is one of its most important work priorities. In August 2017, the *Opinions on Further Guiding and Regulating the Direction of Overseas Investments* indicated the government's support for qualified domestic companies to begin active yet prudent investment in overseas infrastructure projects that will contribute to the connectivity of infrastructure along the `Belt and Road' region. These companies are encouraged to deepen international production capacity cooperation so as to boost the export of competitive domestic industrial capacity, high-quality equipment, and applicable technology.[112]

On 20 June 2017, the NDRC and the State Oceanic Administration jointly issued the *Vision for Maritime Cooperation under the 'Belt and Road' Initiative*, calling for China to work with partner countries to develop three maritime routes: from China through the Indian Ocean to Africa and the Mediterranean, from China across Oceania to the South Pacific, and from China across the Arctic Ocean to Europe.[113] This will create opportunities for cooperation between Chinese and foreign companies in fields such as the marine industries, oceanographic research and technology, and port construction and operation.

On 14 May 2017, President Xi Jinping, speaking at the opening ceremony of the Belt and Road Forum for International Cooperation, declared that China will increase its financial support to the implementation of the initiative, committing an additional RMB 100 billion (USD 14.8 billion) to the Silk Road Fund, and encouraging financial institutions to offer offshore RMB-denominated funds to an expected tune of RMB 300 billion (USD 44.4 billion).[114] China Development Bank and the Export-Import Bank of China are issuing loans equivalent to RMB 250 billion (USD 37.0 billion) and RMB 130 billion (USD 19.2 billion) respectively,[115] to support infrastructure development, production capacity cooperation and financial cooperation along the 'Belt and Road'. China will also work with the Asian Infrastructure Investment Bank (AIIB), BRICS New Development Bank, World Bank and other multilateral development finance institutions to support 'Belt and Road' projects.[116]

According to the NDRC, supported by policy funding, China's total outbound investment between 2017 and 2021 will reach USD 600-800 billion, a significant portion of which will be invested in 'Belt and Road' countries.[117] It is therefore reasonable to expect that in the foreseeable future, the 'Belt and Road' region will emerge as the fastest growing destination for Chinese ODI.

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110 'MOFCOM: Chinese companies' investments in "Belt and Road" countries emerge as a highlight in 2016', China Daily, 17 January 2017, http://caijing.chinadaily.com.cn/finance/2017-01/17/content_27973868.htm

111 'MOFCOM Department of Outward Investment and Economic Cooperation Comments on China's Outward Investment Cooperation in 2017', Ministry of Commerce, 18 January 2018, http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201801/20180102706193.shtml

112 'Opinions on Further Guiding and Regulating the Direction of Overseas Investments', State Council of the People's Republic of China, 18 August 2017, http://www.gov.cn/zhengce/content/2017-08/18/content_5218665.htm

113 'Vision for Maritime Cooperation under the Belt and Road Initiative', Xinhuanet, 20 June 2017, http://news.xinhuanet.com/politics/2017-06/20/c_1121176798.htm

114 RMB to USD conversions calculated based on the average exchange rate in 2017

115 RMB to USD conversions calculated based on the average exchange rate in 2017

116 All information relative to the Belt and Road Forum for International Cooperation in this paragraph was sourced from the keynote speech that President Xi Jinping delivered at the Forum. See: 'Work Together to Build the Silk Road Economic Belt and the 21st Century Maritime Silk Road', H.E. Xi Jinping, President of the People's Republic of China, 14 May 2017, http://www.xinhuanet.com/english/2017-05/14/c_136282982.htm

117 'How much future investment in the "Belt and Road"? Here's the NDRC response', Sina News, 12 May 2017, http://news.sina.com.cn/c/nd/2017-05-12/doc-ifyfeivp5648207.shtml

3. China's model of outbound investment is being continually improved and refined

After years of experience, the model of Chinese outbound investment has already achieved a level of maturity and is constantly being refined. Cross-border M&A and equity investment have emerged as the primary forms of Chinese ODI, and privately owned and state-owned companies are making steady progress in their overseas investments. At the same time, by actively working to promote private capital participation in the development of the BRI, the Chinese Government is looking to improve the current business model where 'sovereign funds' and 'state capital'[118] are still the main players.

3.1 Cross-border M&A is emerging as the primary form of investment

As China has become stronger and its companies more competitive, more Chinese privately and state-owned companies are investing abroad, and outbound M&A is emerging as an important way for them to 'go out'. Since 2008, and with the exception of 2014, outbound M&A deals have accounted for more than 45% of Chinese ODI by value, and in some years have even surpassed the share of greenfield investment (Figure 57).

In 2016, the value of announced overseas M&A deals by mainland Chinese companies rose as much as 121%. Thirty-seven of these transactions closed for over USD 1 billion, compared to 23 in 2015.[119] That an increasing number of Chinese companies are choosing cross-border M&A as a key means of expanding overseas is in line with global investment development trends and indicates that China's outbound investment model is becoming more mature.

3.2 Equity investment is becoming an important tool for making overseas investments

Chinese companies are pursuing more strategic aims in their overseas expansion, increasingly using equity investment as a means to acquire the resources to operate globally and move up the global value chain to take a more leading position.

In 2016, new equity investments valued at USD 114.1 billion accounted for 58.2% of China's total ODI flows. Although this was lower than the proportion reached in 2015 (i.e. 66.4%), it was higher than the average for the last decade. Meanwhile, reinvested returns reached USD 30.6 billion in 2016, representing 15.6% of total ODI flows, while investment through debt instruments reached USD 51.4 billion, and accounted for 26.2% of total ODI flows (Figure 58).

3.3 Private and state-owned companies join forces to 'go out'

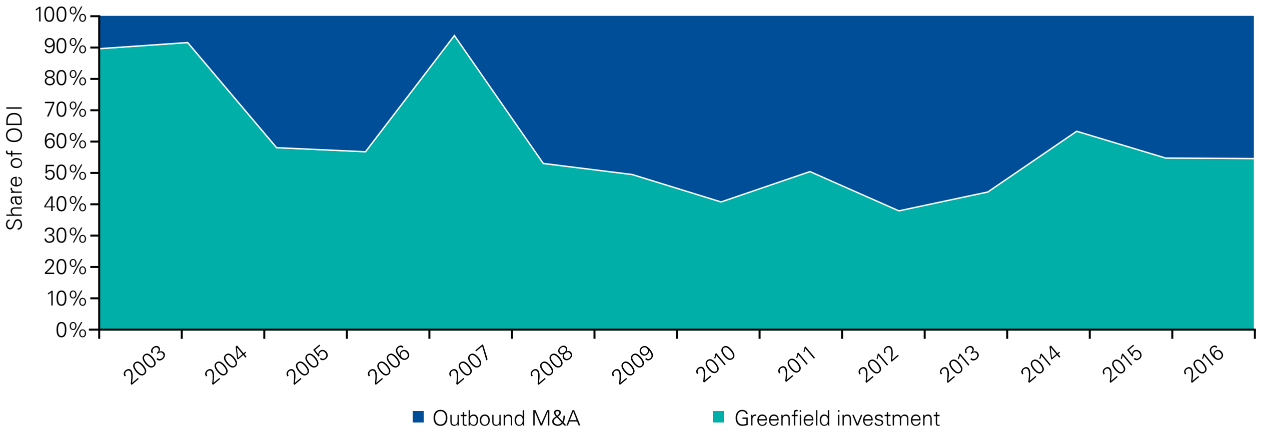
China's earliest outbound investors – primarily SOEs – relied largely on government planning. In recent years, however, the drivers of Chinese outbound investment have been more effective in creating a balance between the state and market forces. Overseas investments from private companies have made up an increasingly larger share of China's total ODI stock over the past decade (Figure 59).

Looking forward, as the BRI continues being implemented, SOEs will be the dominant investors in the infrastructure development of 'Belt and Road' countries. Once these projects are completed and the regional and global market potential is gradually unleashed, private companies will make more investments in the development of local industrial capacity and consumer markets; as such, the implementation of the BRI will further the synergistic development of overseas investments by SOEs and private companies.

[118] 'Sovereign funds' refers primarily to sovereign wealth funds such as China Investment Corporation. 'State capital' typically represents capital from state-owned enterprises and development finance capital.

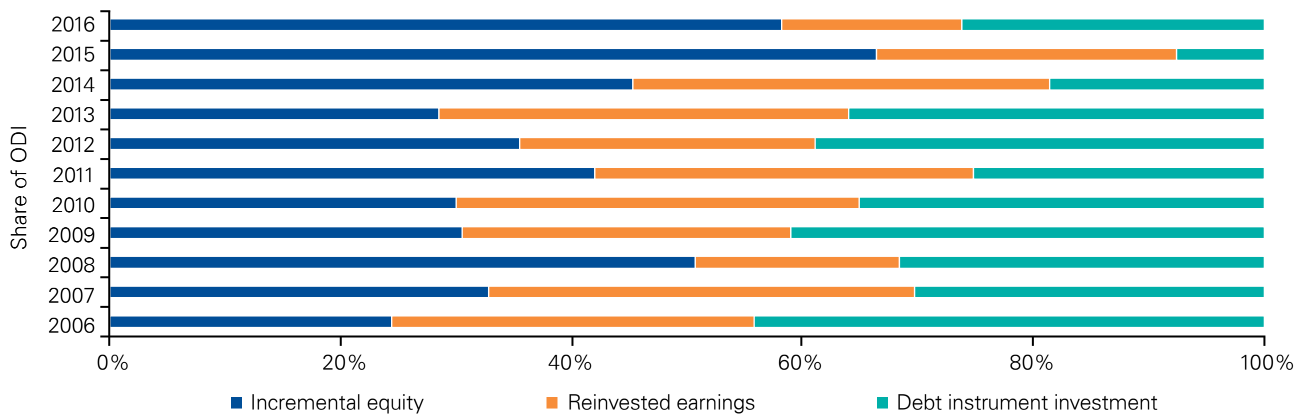
[119] Calculation is based on data extracted from Dealogic on 6 February 2017.

Figure 57: Outbound M&A vs greenfield investment as a share of total Chinese ODI by value



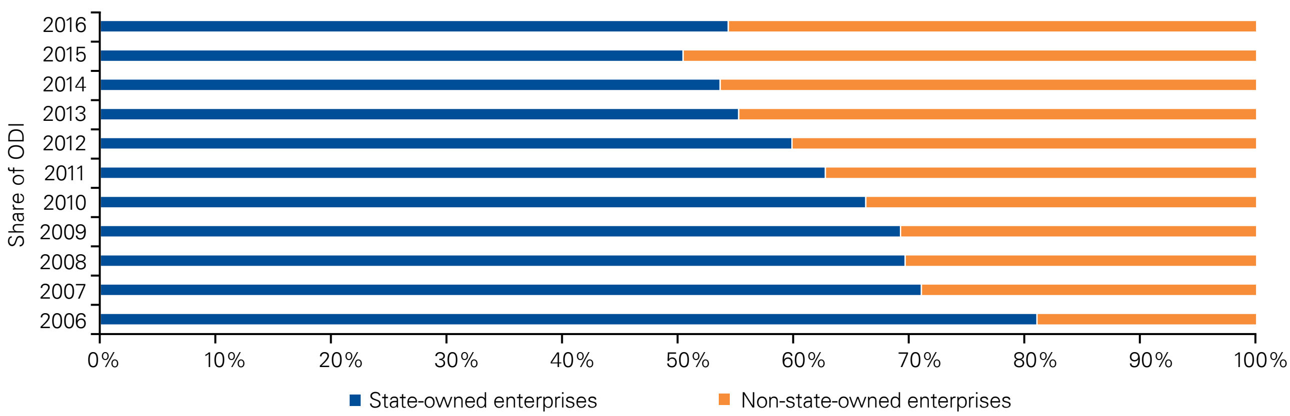
Source: UNCTAD; WIND

Figure 58: Structure of China's ODI flows



Source: National Bureau of Statistics of China; Ministry of Commerce of China

Figure 59: State-owned vs private capital as a proportion of China's total ODI stock



Source: National Bureau of Statistics of China; Ministry of Commerce of China

3.4 Cooperation between China's state capital and sovereign funds, and private capital from China and abroad

Development financing institutions are beginning to cooperate with commercial banks and private capital in supporting Chinese companies to 'go out'.[120] SOEs have also begun collaborating with private companies on overseas M&A deals.[121]

In terms of cooperation between Chinese and foreign investors, President Xi Jinping, speaking at the Belt and Road Forum for International Cooperation, noted that China will work with other countries to: establish a financial safeguard system that keeps risks under control; develop new financing and investment models; promote more cooperation between private and public sources of capital; promote the development of a diverse fundraising system and a multi-tiered capital market; and broaden financial inclusion, while developing a sophisticated financial services network.[122]

The *Joint Communique of the Leaders Roundtable of the Belt and Road Forum for International Cooperation* calls on nations to: maximise synergies in infrastructure planning and development by taking into account international standards where applicable, and by aiming to harmonise rules and technological standards across countries when necessary; foster a favourable environment and predictability for infrastructure investment by private capital; promote public-private partnership (PPP) in areas that create more jobs and generate greater efficiency; and welcome international financial institutions to increase support and investment for infrastructure development.[123]

The Chinese Government is actively working with foreign governments, international organisations and professional service providers to support the implementation of the BRI and increase the supply of bankable infrastructure projects by establishing PPP mechanisms,[124] improving institutional capacity in host 'Belt and Road' countries, facilitating project design and marketing, and improving the business environment for project implementation. Thanks to these measures, we expect that going forward, international private capital will have more opportunities to invest alongside Chinese state capital, sovereign wealth funds and Chinese private capital in infrastructure development projects along the 'Belt and Road'.

Greater participation from private capital will create market opportunities for Chinese companies and companies from third countries (i.e. from outside China and the host country) in project advisory services, investment and financing, operating and managing the infrastructure assets, and other professional services, as well as for suppliers of advanced equipment and raw materials.

[120] The Chinese Government is currently encouraging greater financing support for equipment manufacturing and international production capacity cooperation through a combination of policy, development and commercial financial sources. For more on this, see: 'Report on Development of China's Outward Investment and Economic Cooperation 2016', Ministry of Commerce, December 2016, http://fec.mofcom.gov.cn/article/tzhzcj/tzhz/upload/zgdwtzhzfzbg2016.pdf

[121] 'Explore new form of mixed ownership, state-owned companies join privately owned companies in overseas M&As', Sina News, 1 May 2014, http://finance.sina.com.cn/china/20140501/072818981710.shtml

[122] 'Work Together to Build the Silk Road Economic Belt and the 21st Century Maritime Silk Road', H.E. Xi Jinping, President of the People's Republic of China, 14 May 2017, http://www.xinhuanet.com/english/2017-05/14/c_136282982.htm

[123] 'Full text: Joint Communique of Leaders Roundtable of Belt and Road Forum', Xinhua News, 15 May 2017, http://news.xinhuanet.com/english/2017-05/15/c_136286378.htm

[124] 'The NDRC and 13 ministerial bodies to establish a PPP working mechanism for the "Belt and Road" Initiative', NDRC, 6 January 2017, http://tzs.ndrc.gov.cn/zttp/PPPxmk/gzdt/201701/t20170106_834560.html

4. Chinese outbound investment has a new role to play in the 'new paradigm of globalisation'

On 17 January 2017, President Xi Jinping delivered a keynote speech at the opening plenary of the World Economic Forum Annual Meeting in Davos, declaring that China "will open [her] arms to the people of other countries and welcome them aboard the express train of China's development."[125]

China is speeding up the practical implementation of a 'new paradigm of globalisation' through the development of the 'Belt and Road' Initiative. At its core, this new paradigm seeks to enable more countries to participate in the international division of labour and share in the benefits of globalisation. The emergence of China's 'new economic cycle' and the country's ongoing economic transformation will further accelerate this process. This means that in addition to being an advocate for this 'new paradigm of globalisation', China is also the primary source of momentum for its development. China will continue with healthy growth in its outbound investment. By doing so, it is shouldering more responsibility in the advancement of the 'new paradigm of globalisation'.

4.1 The 'new paradigm of globalisation' will revitalise global cross-border investment

The WTO has reported that from the 1990s until 2008, global trade in goods grew at more than double the pace of GDP. In recent years, however, following a global slowdown in growth and the rise of trade protectionism, this ratio has come down considerably, settling at roughly 1 to 1.5, and in 2016 growth in trade actually dipped below global GDP growth.[126] As growth in trade has fallen, there has been a corresponding decline in global cross-border investment. These two factors have contributed to an overall weakening in global economic activity.

The traditional model of globalisation has three limiting factors: (i) a small number of nations setting the rules of globalisation; (ii) long-term account imbalances between resource-, manufacturing- and consumption-oriented economies; and (iii) the difficulties faced by some developing nations to participate in and therefore benefit from globalisation. These limitations were some of the root causes of the 2008 financial crisis. They are also some of the key reasons for sluggish global growth in recent years.

This is why it is difficult to see how global trade and investment will stabilise and rise again under the traditional model of globalisation, and why achieving global economic recovery will also be difficult. In proposing the BRI, the Chinese Government is promoting a 'new paradigm of globalisation' rooted in peaceful cooperation, openness and inclusiveness, mutual learning, and mutual benefit. By overcoming the inequalities, imbalances and lack of inclusiveness inherent in the traditional model of globalisation, the BRI has the potential to provide enduring support for a resurgence in global trade and investment.

4.2 At the core of the 'new paradigm of globalisation' lies a realignment of the global industrial value chain and a readjustment of global trade and investment

The wave of globalisation that swept the world following World War II was built on an international division of labour between resource-, manufacturing- and consumption-oriented economies. After decades of cross-border trade and investment, and with the impact of the 2008 financial crisis, the inherent flaws of this model have become clear.

This is why at the core of the 'new paradigm of globalisation' is the restructuring of global industrial value chains, along with a corresponding adjustment to the sources and directions of global trade and investment. To this end, the Chinese prescription considers three key actions:

- The rules that currently govern the international division of labour, and which were decided by a small group of nations, need to be changed in favour of rules for globalisation that are formed through consultation among all participants in the global value chain. Furthermore, all participants should have an equal voice in these deliberations.
- The imbalances in the global economy must be adequately addressed through a consultative process that yields a new mechanism of globalisation defined by fair trade and reciprocal investment.
- Underdeveloped nations and regions must be brought into the new international division of labour. In order to achieve this, a key priority will be helping these countries improve infrastructure and the capacity of their institutions.

These three key actions will be necessary in order to address the shortcomings and contradictions of the traditional model of globalisation, and to create a new model that is aligned with emerging trends in the world economy, so that global trade and cross-border investment can flourish again.

[125] 'Full text: Xi Jinping's keynote speech at the World Economic Forum', The State Council Information Office, 6 April 2017, http://www.china.org.cn/node_7247529/content_40569136.htm

[126] According to the WTO, the ratio of global growth in trade to GDP growth averaged 2.0 from 1990-2008, 1.5 from 2010-2015, and fell to 0.6 by 2016. This shows that growth in global trade is now lower than global GDP growth. See: 'World Trade Statistical Review 2017', WTO, August 2017, https://www.wto.org/english/res_e/statis_e/wts2017_e/wts17_toc_e.htm

4.3 China's transformation and outbound investment will drive a new boom in global investment

As the world's largest manufacturing and trading economy, the third largest destination for foreign investment and the second largest outbound investor,[127] China has a critical role to play in the realignment of the global value chain. China's transformation and outbound investment will be key factors in the restructuring of global industrial value chains and the promotion of cross-border investment worldwide.

As described above, when countries cross the threshold into high-income nations, they typically enter a phase of rapid growth in outbound investment. Given this natural trend, Chinese companies may have a greater appetite for outbound investment moving forward. As the world's second largest economy, steady and healthy growth of China's outbound investment will contribute to a new wave of growth in global investment, as well as enable the acquisition of quality external resources to support the transformation and upgrading of China's domestic industries. This transformation also requires China to transfer quality, surplus production capacity to emerging industrialised economies and expand its development of overseas markets, thereby driving Chinese companies to increase their investments in developing and emerging economies. These factors suggest that steady growth in China's outbound investment is an irreversible trend that will continue over the long term, and will help drive cross-border investment activity.

[127] Data from UNCTAD; and 'MIIT interprets "Made in China 2025" (Part II): Already the world's No. 1 manufacturer', Xinhuanet, 19 May 2015, http://news.xinhuanet.com/fortune/2015-05/19/c_127818497.htm

5. Chinese and foreign companies are strengthening collaboration in third-country markets

China's advocacy for the BRI is rooted in a commitment to the basic principle of achieving shared growth through discussion and collaboration. The initiative "accommodates the interests and concerns of all parties involved, and seeks a conjunction of interests and the 'biggest common denominator' for cooperation so as to give full play to the wisdom and creativity, strengths and potentials of all parties."[128]

Collaboration between Chinese and foreign companies in third-country markets represents an important path towards unlocking this potential and achieving synergies, where the total value of collaboration of the three parties can be greater than the sum of their parts. This collaboration will also become an important form of Chinese outbound investment in the 'new paradigm of globalisation'. Chinese and foreign companies should cooperate in ways that combine Chinese capital and production capacity with technology and equipment from developed nations, thereby bringing technology-rich, cost-effective products and services to global markets, especially in developing nations.

5.1 The development of the 'Belt and Road' Initiative opens up the potential for collaboration in third-country markets

As mentioned, at its core, the concept and practical implementation of the BRI through the 'new paradigm of globalisation' envisages a realignment of global industrial value chains and adjustments in global trade and investment. This will necessarily lead to shifts in industry and will catalyse new cross-border investment activity. However, this transition will differ from the shifts that occurred in the last round of globalisation, such as the shifts in industry from the US to Japan; from the US and Japan to the Four Asian Tiger economies; and from the US, Japan and the Four Asian Tigers to China. Given the increase in the number of industrialised nations, as well as China's promotion of the 'new paradigm of globalisation' and the BRI, this coming shift in industry may feature two or three countries jointly contributing to a nation's industrialisation, thereby laying a foundation for multiple countries to collaborate in the development of third-country markets.

Of course, China cannot implement the BRI on a global scale by relying solely on its own efforts and resources. The implementation of this initiative will require the participation and support of many partner countries in pursuit of mutual benefit. This also creates an important opportunity for China to work with other nations to develop third-country markets. Given the contraction of global markets since the financial crisis, both developed and emerging economies have experienced a significant slowdown in growth. There is an urgent need to tap new market opportunities so as to achieve a quick recovery in the drivers and resilience of economic growth. With this in mind, the Chinese Government has begun exploring potential areas and models of third-country market cooperation with the UK, France, Germany and South Korea (Table 6). With the continued evolution of the 'new paradigm of globalisation' and the ongoing implementation of the BRI, there will be an increasingly broad horizon for cooperation between Chinese and foreign companies in third-country markets.

[128] 'Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road', NDRC, 28 March 2015, http://en.ndrc.gov.cn/newsrelease/201503/t20150330_669367.html

Table 6: Agreements and protocols concluded between China and major nations on cooperation in third-country markets

Partner country	Agreement/Protocol	Scope and mode of cooperation
UK	*Memorandum on Cooperation in Promoting Investment and Export to Africa* and other bilateral memoranda signed during leadership meetings	Industrial cooperation in Africa between China, the UK and African nations to promote the Partnership for Investment and Growth in Africa (PIGA); collaboration in the form of joint investment, research and training along the 'Belt and Road'
France	*Joint Statement by the Governments of China and France on Partnerships in Third-country Markets*	Promote third-country collaboration in areas such as infrastructure, energy, civil aircraft, transport infrastructure, agriculture, healthcare, pharmaceuticals and climate change; leverage the technical capacities of both countries to develop joint projects and create value added in the industrial parks of third-party countries and regions; identify ways in which the finance and insurance sectors can facilitate the cooperation of French and Chinese companies in third-country markets
Germany	*The 4th Round of China-Germany Government Negotiation Joint Declaration*	Joint training of mining industry talents alongside capacity building in the humanitarian and disaster relief sectors in Afghanistan; third-country cooperation in areas such as infrastructure, energy, transportation, environmental protection, agriculture and healthcare; collaboration in the development of the BRI and pan-Eurasian transport infrastructure; support for cooperation on high-speed rail between CRRC Corporation Limited and Siemens in third-country markets; and support for strengthening the strategic cooperation between China Railway Corporation and Deutsche Bahn on Europe-China rail connectivity and on high-speed rail operations, maintenance and development in third-country markets
South Korea	*China-Korea Memorandum of Cooperation in International Industrial Capacity and Jointly Developing Third-Country Markets*	Collaboration in third-country markets in areas such as innovation, smart manufacturing and high-tech R&D

Source: Extracted from agreements and protocols between China and major nations

5.2 Cooperation in third-country markets will cover multiple sectors

An analysis of the stages of development of the 'Belt and Road' Initiative suggests that near-term collaboration between Chinese and foreign companies in third-country markets will be focused on infrastructure development and production capacity. This collaboration may take the form of jointly established investment funds, industrial parks, joint ventures or other joint projects. Chinese and foreign companies may consider pursuing different forms of collaboration in a broad range of sectors, including resource extraction, modern agriculture, high-tech manufacturing and modern services, to form a multi-tiered,[129] multi-modal framework of industrial cooperation (Table 7).

In *Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road,*[130] the Chinese Government describes the scope of the

Table 7: Major sectors, destination countries and potential modes of cooperation between Chinese and foreign companies in third-country markets

Major sectors	Strengths of Chinese partners	Strengths of foreign partners
Infrastructure	Construction capabilities and experience; access to 'state capital' and sovereign wealth funds (SWFs)	Infrastructure technologies; using commercial financing capabilities and experience of managing and operating infrastructure assets
Resource extraction	Extraction capabilities; large demand for resources from the Chinese domestic market	Eco-friendly extraction techniques/ technologies; international commodity bargaining and pricing power
Modern agriculture	Experience in agricultural production; abundance of talent trained in agricultural technologies	New biological technologies used in modern agriculture; using commercial financing capabilities
Processing and manufacturing	Potential for production capacity transfers; production capabilities and experience	Modern industrial technologies such as automation; high efficiency in manufacturing
High-tech manufacturing	Manufacturing production capabilities	Advanced technologies; R&D capabilities
Ecology	Access to 'state capital' and SWFs; China is pushing to develop its 'green' industries domestically	Eco-friendly techniques/technologies; capital management capabilities
Trade and logistics	Building logistics parks	Operating experience and capabilities in logistics
Finance	RMB internationalisation; access to 'state capital' and SWFs	Capital management capabilities; capabilities and experience at operating market-oriented financing
Other services	Building infrastructure to support the services sector; technical talent in the services sector; access to 'state capital' and SWFs	Capital management experience; providing services and managing/ operating the related infrastructure

Source: KPMG analysis
Note: 'State capital' typically represents capital from state-owned enterprises and development finance capital (see footnote 118). 'Other services' include culture, education, healthcare, senior care and travel

[129] In this context, 'multi-tiered' multi-model cooperation means that governments, institutions and enterprises will be involved in various forms of cooperation across a broad range of sectors.

[130] 'Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road', NDRC, 28 March 2015, http://en.ndrc.gov.cn/newsrelease/201503/t20150330_669367.html

BRI as being based on but not limited by the path of the ancient Silk Road; all countries as well as international and regional organisations are eligible to participate. Collaboration between Chinese and foreign companies in third-country markets, therefore, is also not limited to the emerging economies and developing nations that lie along the 'Belt and Road' route; potential third-country markets include developed nations, especially those with a demand for infrastructure improvements. Chinese companies should work with foreign partners to build a large-scale, multi-tiered, multi-modal framework for cooperation in third-country markets, based on realistic commercial terms, and the needs of the host country in each case.

This approach represents the future form and direction of Chinese outbound investment. Foreign companies, for their part, should be open to collaborating with Chinese companies, and participate in the development of the BRI to achieve mutual benefit and win-win outcomes.

Target host countries for cooperation	Potential modes of cooperation
Developing nations with weak infrastructure, and emerging and developed nations with an urgent need to upgrade their infrastructure	Forming infrastructure investment funds and project companies; cooperating in PPP advisory and implementation of PPP projects
Resource-rich countries	Co-investing in mining projects; forming companies to acquire extraction rights; operating mines
Countries where agriculture represents a relatively large proportion of the economy; poor countries which are rich in agricultural resources	Conducting agricultural training programmes and scientific research; forming project companies to build farms and operate 'big farming' projects and health food-related industries[131]
Countries in the early and mid-stages of industrialisation	Building industrial parks and forming equity joint ventures
Emerging markets and developed nations	Forming R&D centres and equity joint ventures in high-tech sectors
Developing nations with severe pollution; emerging markets and developed nations with a need to improve the 'greenness' of their economies	Developing green financial products; forming companies to provide comprehensive environmental solutions and related services; undertaking 'green' PPP projects
Important logistics hubs along the 'Belt and Road'	Developing logistics hubs; operating logistics parks and logistics services companies
Important global, regional and local financial centres	Creating a 'Belt and Road' financing platform; developing financial products to support 'Belt and Road' projects; establishing offshore centres for the internationalisation of the RMB
Emerging markets and developing nations with insufficient development of public services and relatively significant market opportunities	Undertaking services sector PPP projects; forming investment funds to promote the development of the services sector; co-developing brands associated with providing services and managing/ operating the related infrastructure

[131] Compared with traditional farming, 'big farming' refers to modern farming in which advanced technologies, new production materials and scientific management are all widely applied. Health food refers to safe, organic and healthy food that will be produced in the third countries and exported to China, some emerging markets and developed countries.

5.3 Managing investment and operating risks in third-country markets

Cooperation in third-country markets is an emerging model of international cooperation and a key feature of the 'new paradigm of globalisation' that China is advancing through the implementation of the BRI. While we expect third-country market cooperation to lead to new strategic opportunities for both Chinese and foreign companies, this new model of cooperation also poses a number of challenges and risks. This is mainly because third-country markets may be unfamiliar for Chinese companies and their international counterparts. Consequently, we believe companies should pay attention to these key points when entering these markets:

- **Be sensitive to political and policy risks:**

  Foreign companies can consider partnering with Chinese companies on projects along the 'Belt and Road', as the Chinese Government has concluded memoranda of understanding or other investment agreements with many host governments of these countries, which will help avoid or reduce the risks associated with local political turbulence and policy shifts.

- **Respect local customs:**

  Chinese and foreign companies need to actively cooperate with local companies by, for example, forming equity joint ventures and hiring local managers. This will not only help deepen the partners' understanding of the local investment climate and local laws and regulations, but also help avoid the various operating risks associated with lack of familiarity with local customs and norms.

- **Consider risks posed by the lack in the supply of critical factor inputs such as talent, capital, technology and infrastructure:**

  Chinese and foreign companies should encourage collaboration between governments in areas including infrastructure development, training, joint R&D and the broadening of channels for investment and financing as a way to reduce these risks in the longer term.


IREMENTS
RULES
STANDARDS
OMPLIANCE
GOVERNANCE
PARENCY
REGULATIONS

Chapter 4

Coordinated development of FDI and ODI: China's inbound and outbound investment in the 'new economic cycle' and the 'new paradigm of globalisation'

China's 'new economic cycle' and the 'new paradigm of globalisation' are closely linked. On the one hand, the 'new paradigm of globalisation' will only truly advance once China's 'new economic cycle' has begun, complete with stable trade and investment flows, and a recovering economy. On the other hand, achieving progress in implementing the 'new paradigm of globalisation' will create a more favourable international climate for China's economy to continue developing steadily in the 'new economic cycle'.

Going forward, Chinese and foreign investors should seize the strategic opportunities that will emerge under the 'new vision of development' that President Xi Jinping advanced at the 19th CPC National Congress, as China enters the 'new economic cycle', and the 'new paradigm of globalisation' gradually gains momentum. They should do this by fine-tuning their awareness of the implications of these developments and adjusting their investment strategies appropriately, including by making more investment in more sectors in China and overseas markets. By broadening and deepening China's FDI and ODI, Chinese and foreign companies can share in the benefits of this 'new paradigm of globalisation' and China's 'new economic cycle', while laying the foundations for healthy and stable development in the Chinese and global economy.

1. A new phase in China: Seeking higher-quality FDI, and 'going out' with a clearer purpose

Over the past two years, China's FDI and ODI diverged sharply, with growth in FDI slowing dramatically just as ODI growth accelerated. In 2016, China's outbound investment flows surpassed inbound flows for the first time, making China a net exporter of capital and attracting great interest from international observers. We believe that while the growth of FDI and ODI are important, it is the quality of FDI and the rationale behind ODI that will ultimately serve China's economic transformation and industrial upgrading in the 'new economic cycle'.

1.1 The 'new paradigm of globalisation' and the 'new economic cycle' will profoundly reshape China's inbound and outbound investment

The process of industrialisation that China has embarked upon since the 'reform and opening up' and the wave of globalisation that began in the 1970s were the main factors behind China attracting massive amounts of FDI. As China's economy enters a new cycle of growth and a nascent form of a 'new paradigm of globalisation' takes shape, both foreign investment in China as well as Chinese outbound investment will be fundamentally reshaped.

Driven by these two factors, based on China's current FDI and ODI trends, we expect that China will soon emerge as both the second largest destination for inbound investment, as well as the second largest source of outbound investment. In addition, structural changes in the drivers of growth in China's 'new economic cycle' and the changes driven by the 'new paradigm of globalisation' will lead to major adjustments in the characteristics of China's FDI and ODI. These adjustments have already begun to manifest in recent years, and will continue to evolve in the future. Finally, the Chinese Government is working to gradually strengthen regulation of FDI and ODI flows. Further reform and opening up measures are aimed at giving foreign companies a more level playing field on which to compete in China, and the strategic rationale and conduct of Chinese companies' outbound investments is being regulated to make ODI more rational and reasonable.

1.2 The new normal and the new cycle call for higher-quality FDI

Firstly, foreign companies should focus on the weak links in China's economic transformation and leverage their strengths in areas such as advanced technologies, business model innovation and modern management practices to enter the Chinese market. Foreign companies should consider increasing their investments in areas such as R&D and brand development. Secondly, foreign companies should take advantage of the opportunities presented by China's ever-expanding middle class by investing in and growing their market share in mid- and high-end sectors in China. Finally, foreign companies should collaborate more with local companies, increase the localisation of their investments, and work to gain greater trust from the government by making a contribution to China's economic transformation.

1.3 The 'new paradigm of globalisation' calls for more rational outbound investment by Chinese companies

Firstly, the BRI will be an important way in which the 'new paradigm of globalisation' advocated by China is realised. Chinese companies should take the lead in implementing this initiative by making sensible investments along the `Belt and Road' in order to unlock the potential of developing nations and emerging economies in the region. Secondly, Chinese companies should 'go out' with the objective of acquiring high-quality resources that they can bring back home to support China's economic transformation. Next, Chinese companies should work to establish a series of successful model projects with improved investment profits and project returns, thereby setting an example for overseas investment in the 'new paradigm of globalisation'. Finally, Chinese companies should improve asset allocation by investing in a variety of assets globally to achieve a reasonable diversification of investment risk.

2. The 'new paradigm of globalisation': China eyes cooperation with the world, and the world eyes Chinese investment

China is an important leader in the future of global governance. China is also the initiator and advocate of the 'new paradigm of globalisation'. The future of China's 'reform and opening up' will be oriented towards achieving mutual benefit and cooperation with all the world's nations. At the same time, given the contraction of global trade and investment, the world is looking to Chinese investment as one of the primary drivers for sustained global economic recovery.

2.1 Chinese companies look forward to win-win cooperation with foreign partners on the global stage

Chinese companies have already set off on a journey of internationalisation, and collaborating more with foreign companies is an important and positive way to achieve this.

- Firstly, Chinese companies should strengthen their collaboration with local companies in host countries; in particular, they should partner with local companies to improve the industrial capacity and related supporting infrastructure in host economies along the 'Belt and Road'. This type of collaboration can help localise the investment and increase its strategic significance.
- Secondly, Chinese companies should work more with leading international companies and professional organisations, leveraging their respective strengths to enter new markets (including developed nations) and jointly develop third-country markets.
- Finally, Chinese companies should continue making equity investments in sectors with high potential, including by co-investing with multinational partners to achieve mutual benefit and win-win outcomes.

2.2 Global economic recovery and the emergence of the 'new paradigm of globalisation' urgently require China's participation

China's growth in outbound investment ranks among the fastest in the world, and continues to make a sizeable contribution to cross-border investment growth globally. From a short-term perspective, Chinese companies' efforts to 'go out' will be an important driver for the post-financial crisis recovery in global trade and investment flows. From a long-term perspective, the outbound flow of Chinese capital has already become an indispensable factor in the global economic recovery.

As implementation of the BRI progresses, efforts by Chinese companies to use their access to capital to make more investments and expand their operations in international markets will provide an important support for the emergence of the 'new paradigm of globalisation'. At the same time, China's vast market demand will also be a significant factor in promoting cross-border investment.

As such, whether from a short-term perspective in terms of improving cross-border trade and investment, or a long-term perspective in terms of global economic recovery and the emergence of the 'new paradigm of globalisation', China's outbound investment is a major factor that will support sustained prosperity in the world economy.

3. Chinese-style transformation: Encouraging two-way capital flows with improved support and conditions for inbound and outbound investment

China's experience over nearly 40 years of 'reform and opening up' reveals a conditional relationship between the two: only through reform can the opening up – and two-way flows and connectivity of capital – be achieved. The Work Report delivered at the 19th CPC National Congress affirms that China will continue to "comprehensively deepen reform", and issues a clear mandate to "get rid of all outdated thinking and ideas and all institutional ailments, and to break through the blockades of vested interests", and instead "develop a set of institutions that are well conceived, fully built, procedure based, and efficiently functioning". The Work Report also states that China will make "new ground in pursuing opening up on all fronts", giving equal emphasis to 'bringing in' and 'going global'.[132]

Given the importance of opening up and reform to achieving the 'great rejuvenation' of the Chinese nation, or the 'Chinese Dream', we expect that China will continue to open up in step with the development of a mature market, reciprocal rules and sound institutions. This openness will have a strong and positive impact on the two-way development of FDI and ODI flows.

3.1 *Easing market access restrictions will be conducive to reaching agreement on how to achieve 'investment reciprocity'*

The Third Plenary Session of the 18th CPC Central Committee adopted the *Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening Reform*, opening a new chapter in the process of China's comprehensive reform. However, from the perspective of many observers in the international community, China's reform agenda has advanced slowly over the last four years, with progress falling below expectations.[133] Some are saying that China's reform has stalled or even moved backwards.

Yet, from the perspective of the Chinese Government, China's reform is advancing at an appropriate pace[134] along a path of market orientation. In July 2017, the NDRC and Ministry of Commerce jointly issued a newly amended *Catalogue for the Guidance of Foreign Investment Industries (Amended in 2017)*.[135] Compared to the 2015 version of the catalogue, the 2017 amendment further expands foreign access to the Chinese market by eliminating 30 restrictive measures on FDI in the services, manufacturing and extractive industries, and by opening a number of high-tech industries, such as virtual reality and augmented reality. The 19th CPC National Congress report goes further in proposing that China will significantly ease market access, further open service sectors, and protect the legitimate rights and interests of foreign investors.[136]

As we can see, through its efforts to continue expanding the scope of industries open to foreign capital, the Chinese Government is laying a positive institutional foundation for China to achieve investment reciprocity with other nations as quickly as possible, and for Chinese and foreign companies to engage in two-way investment.

3.2 *Strengthening supervision and regulation of market conduct will help ensure fair competition between state-owned and non-state-owned, and between Chinese and foreign-owned enterprises*

The Work Report of the 19th CPC National Congress reiterated that the Chinese Government will concentrate on improving the property rights system and ensuring the market-based allocation of factors of production, so that property rights act as effective incentives. According to the Work Report, China will also work towards ensuring free flows of factors, flexible prices, and fair and orderly competition, and that business survival is determined by competition. Meanwhile, China will also deepen reform in the business sector, break administrative monopolies and prevent the forming of market monopolies.[137]

- Firstly, China's anti-monopoly regulation will be normalised according to set laws, procedures and standards, thereby yielding a more predictable arena for competition in the Chinese market. This will help improve the investment climate and enhance China's ability to attract foreign capital.
- Secondly, the Chinese Government is accelerating the development of a fair competition review system to effectively check the government's administrative monopoly. This will create a positive market environment for foreign investors in China.

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[132] 'Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era (Delivered at the 19th National Congress of the CPC, October 18, 2017, Xi Jinping)', Xinhua News, 18 October 2017, http://www.xinhuanet.com/english/download/Xi_Jinping's_report_at_19th_CPC_National_Congress.pdf

[133] According to the latest *Business Confidence Survey* by the EU Chamber of Commerce in China, while European companies recognise that notable improvements have been made in terms of IPR protection and anti-corruption in China, they continue to have a low degree of confidence in the progress of implementing the economic, rule of law and state-owned enterprise reforms proposed in the Third Plenary Session of the 18th CPC Central Committee. See: 'Business Confidence Survey 2017', EUCCC, May 2017, http://www.europeanchamber.com.cn/en/publications-business-confidence-survey

[134] 'Appropriate pace' is primarily reflected in three aspects: (1) the pace of reforms needed to find a balance between advancing the reform and maintaining stable economic growth in the short term; (2) the reforms start steadily, and then speed up, to ensure the direction of reforms is correct; (3) the Chinese Government initially focuses on accelerating reforms in key areas and, after making breakthroughs in these key areas, moves to advance reforms in other areas.

[135] 'Catalogue for the Guidance of Foreign Investment Industries (Amended in 2017)', NDRC, June 2017, http://wzs.ndrc.gov.cn/zcfg/201706/W020170628553908627683.pdf

[136] 'Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era (Delivered at the 19th National Congress of the CPC, October 18, 2017, Xi Jinping)', Xinhua News, 18 October 2017, http://www.xinhuanet.com/english/download/Xi_Jinping's_report_at_19th_CPC_National_Congress.pdf

[137] 'Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era (Delivered at the 19th National Congress of the CPC, October 18, 2017, Xi Jinping)', Xinhua News, 18 October 2017, http://www.xinhuanet.com/english/download/Xi_Jinping's_report_at_19th_CPC_National_Congress.pdf

- Finally, the Chinese Government is accelerating the reform of SOEs and monopolistic sectors by easing market entry restrictions and narrowing the scope of government price controls. SOEs will be encouraged to divest from competitive sectors, and SOE managers will primarily be tasked with managing capital rather than people and assets.

Once implemented, these measures will offer important institutional support for fair competition between foreign companies and Chinese companies, particularly SOEs.

3.3 Regulating two-way investment flows will help maintain market order for FDI and ODI

The liberalisation of China's market for factors of production is entering a new phase. Previous years saw the steady opening up of sectors, modes and channels of investment. Now, a shift towards 'Openness + regulation'[138] is helping achieve a new pattern of comprehensive openness.

In addition to expanding the sectors into which foreign investment may be made, simplifying the procedures, and making it easier for foreign direct investment to access the market, China is also committed to promoting trade and investment liberalisation and facilitation, as well as implementing the system of pre-establishment national treatment plus a negative list 'across the board'.[139] The foreign investment negative list, tested in free trade zones, will be implemented nationwide, and will cultivate an even more open, transparent and well-managed investment climate.[140]

By deepening reforms of the institutions that govern outbound investment, and by providing more guidance and stepping up regulation of the direction of Chinese outbound investment, the government is encouraging greater rationality in outbound investment activities, seeking to prevent and manage outbound investment risks, and push for the sustained and healthy development of overseas investment to achieve mutual benefit and shared development alongside the host countries.[141]

Improved management of two-way capital flows will not reduce the level of openness in the economy, but will rather advance a more sustainable openness through the clarification of rules and the strengthening of governance practices. This will not only promote more fair competition in the Chinese domestic market, but also help maintain order in global markets.

3.4 Deepening financial system reform will improve the support and conditions for FDI and ODI

As China's FDI and ODI gradually enter a stage of mature development, the financial system is emerging as a critically important support for these investment flows. China is both strengthening its domestic financial regulations to ensure the stability of financial markets, as well as accelerating plans to open its financial markets to broader participation. These financial system reforms will provide a safer environment for foreign companies to invest and operate in China, and will also give them access to more financial services.

In parallel to these reforms, China will continue to promote the internationalisation of the RMB, make gradual progress towards achieving capital account convertibility, and advance financial innovation along the 'Belt and Road'. This will be conducive to Chinese companies being able to leverage access to financing to support their 'going out', and will also create opportunities for foreign financial institutions to participate in the development of the 'Belt and Road' Initiative.[142]

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[138] Under the 'Openness + regulation' model, at the same time as easing market access for foreign investment, the Chinese Government will work towards improving the systems and institutions for managing foreign investment, and completing national security reviews to ensure that foreign investment is undertaken in compliance with China's laws and regulations. See: 'Ministry of Commerce comments on amending Foreign Investment Law: While expanding the opening up, Chinese Government will work on improving the institutional systems of managing foreign investment', Sina Finance, 19 January 2015, http://finance.sina.com.cn/china/hgjj/20150119/170421332796.shtml

[139] 'Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era (Delivered at the 19th National Congress of the CPC, October 18, 2017, Xi Jinping)', Xinhua News, 18 October 2017, http://www.xinhuanet.com/english/download/Xi_Jinping's_report_at_19th_CPC_National_Congress.pdf

[140] 'Circular of the State Council on Several Measures to Boost the Growth of Foreign Investment', State Council of the People's Republic of China, 16 August 2017, http://www.gov.cn/zhengce/content/2017-08/16/content_5218057.htm

[141] 'Opinions on Further Guiding and Regulating the Direction of Overseas Investments', Chinese Central Government, 18 August 2017, http://www.gov.cn/zhengce/content/2017-08/18/content_5218665.htm

[142] 'National Financial Work Conference held in Beijing', Chinese Central Government, 15 July 2017, https://www.gov.cn/xinwen/2017-07/15/content_5210774.htm

Conclusion

2018 marks the 10th anniversary of the global financial crisis, as well as the first year of China's new administration following the 19th CPC National Congress. Both China and the world economy will enter a new period and new phase of development. At this historical point in time, we are beginning to see the first outlines of China's 'new economic cycle' and the 'new paradigm of globalisation'. After a decade of sustained decline in global trade and investment, Chinese and foreign companies are now seeing some reasons for being hopeful of an upswing on the horizon.

However, any economic recovery or the establishment of a new model of investment and trade will be a non-linear process, with fits and starts, and possibly detours. Chinese and foreign companies should be alert to the benefits and opportunities, while also being mindful of the inherent risks and challenges. By carefully assessing emerging trends and by acting at the right moment according to one's capability and with a sense of precaution, companies can participate in and advance the emergence of the beginning of China's 'new economic cycle' and the formation of the 'new paradigm of globalisation'. Through these efforts, Chinese and foreign companies have the opportunity to contribute to and shape the emergence of a new period of economic development in China, and prosperity in global investment and trade.

Acknowledgements

NDRC Institute of Market Economy and Competition Policy Research

The NDRC Institute of Market Economy and Competition Policy Research is an authority on global and Chinese market economics. In the course of writing this report, they provided valuable comments and suggestions which were very helpful in offering readers a comprehensive understanding of the opportunities and risks for China's FDI and ODI in the 'new economic cycle' and under the 'new paradigm of globalisation'. We express our sincere gratitude for this assistance.

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A note on the data and information presented in this report

KPMG's Global China Practice has made every effort to verify the accuracy of the data and other information presented in this report, which is current as at 1 March 2018 unless otherwise stated.

About KPMG China

KPMG China operates in 17 cities across China, with around 12,000 partners and staff in Beijing, Beijing Zhongguancun, Chengdu, Chongqing, Foshan, Fuzhou, Guangzhou, Hangzhou, Nanjing, Qingdao, Shanghai, Shenyang, Shenzhen, Tianjin, Wuhan, Xiamen, Hong Kong SAR and Macau SAR. With a single management structure across all these offices, KPMG China can deploy experienced professionals efficiently, wherever our client is located.

KPMG International is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 154 countries and territories and have 200,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

In 1992, KPMG became the first international accounting network to be granted a joint venture licence in mainland China. KPMG China was also the first among the Big Four in mainland China to convert from a joint venture to a special general partnership, as of 1 August 2012. Additionally, the Hong Kong office can trace its origins to 1945. This early commitment to the China market, together with an unwavering focus on quality, has been the foundation for accumulated industry experience, and is reflected in the Chinese member firm's appointment by some of China's most prestigious companies.

KPMG's Global China Practice (GCP)

With dedicated teams in nearly 60 locations around the world, including countries and regions along the 'Belt and Road', the Global China Practice plays a leading role in 'bringing China to the world' and 'bringing the world to China'.

We are passionate about facilitating Chinese outward direct investment (ODI) in meaningful ways, including by helping Chinese companies integrate into local business communities, and introducing them to potential partners in key overseas markets. The Global China Practice also enhances KPMG's ability to serve foreign companies as they enter and grow in China. While many of our clients have been active in China for decades, the 13th Five-Year Plan represents an important turning point in the Chinese Government's attitude towards foreign direct investment (FDI), and marks a new era of potential Sino-foreign cooperation in China. To succeed in the 'new normal' in China, foreign companies should review what contribution they can make to China's ongoing economic transformation, align their value proposition and business strategies accordingly, and prepare for a shifting landscape of risks.

Through the Global China Practice, KPMG works alongside both Chinese and foreign companies as they navigate through dynamic business environments, shape business partnerships, and build platforms to achieve long-term market positions.

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Publication number: HK-GCP18-0001

Publication date: March 2018